1113

ECONOMICS OF DEFENSE POLICY: ADM. H. G. RICKOVER

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

SECOND SESSION

PART 4

SHIPBUILDING CLAIMS

Printed for the use of the Joint Economic Committee

ECONOMICS OF DEFENSE POLICY: ADM. H. G. RICKOVER

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

SECOND SESSION

PART 4

SHIPBUILDING CLAIMS

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

92-782 O WASHINGTON : 1982

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

CONTENTS

SHIPBUILDING CLAIMS

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H - 1385
23 September 1969

MEMORANDUM FOR THE GENERAL COUNSEL, DEPARTMENT OF THE NAVY

Subj: Failure of the Justice Department to uphold the public interest in settlement of two lawsuits involving the E. L. Weigand Company and the Navy

1. For the past several years the Navy has been involved in two lawsuits with the E. L. Weigand Company. The Justice Department is handling the litigation for the Government.

2. In the first case, Weigand overcharged the Navy by $163,000 under a subcontract for pressurizer heaters used in naval nuclear propulsion plants. The overcharges were discovered and reported by the General Accounting Office in 1964. In submitting certified cost breakdowns required by the Truth-in-Negotiations Act, Weigand certified that "the information contained in this proposal has been based upon or compiled from the books and records of this company and is accurate to the best of my knowledge and belief". However, the cost and pricing information to which Weigand certified was not based upon or compiled from its books or records. Weigand's accounting system did not even show the cost of performing the orders.

3. Upon the recommendation of the Navy, the Justice Department filed suit against Weigand under the False Claims Act to recover the overcharges, double damages, plus costs as provided for by the Act. The Government's total claim against Weigand exceeded $326,000. Although the amount of money involved in this case was not particularly large by Government standards, the case was very important in principle. A strong Government stand in this case would serve as effective warning to other contractors that they cannot with impunity provide false cost data to the Government. The case offered an excellent opportunity to establish a standard of integrity for Government contracting.

4. In the second case, Weigand sued the Government for infringement of a patent pertaining to pressurizer heaters used in naval nuclear propulsion plants. The Navy concluded that Weigand's claim was invalid. Navy patent counsel determined the Government had a strong defense on the basis that:

a. The patent owned by Weigand was invalid and the invention was unpatentable.

b. The Government already had rights to at least a royalty-free license to use the Weigand patent.

5. Recently I was informed that the Justice Department had reached a settlement with Weigand covering these two cases. Under the settlement, the Government and Weigand will drop their respective lawsuits. Weigand will pay the Government $25,000 in settlement of the $326,000 false claims suit and will grant the Government a royalty-free license to use the Weigand patent.

08H - 1385

6. I do not consider such a settlement to be in the public interest. The $25,000 token cash payment by Weigand does not even cover the $163,000 overcharge to the Government. For that matter, I am sure it does not cover the cost of the Navy effort spent to date in this case. I was told that in making the settlement the Justice Department assigned a value of $200,000 to the royalty-free license. Based on the Navy position, the royalty-free license has no value since the Government already has such rights and, in all likelihood, the patent is invalid. Even if the patent were determined to be valid, I believe it should rightfully belong in the public domain because it grew out of Government-financed development efforts to obtain pressurizer heaters suitable for application in the field of atomic energy.

7. I understand that the Justice Department settled these two cases without officially consulting the Navy regarding the terms of the proposed settlement. The settlement undermines the efforts of those in Government charged with the responsibility of enforcing Government contracts and obtaining the Government's work as economically as possible.

8. These two cases were an opportunity to strengthen the Government's hand in dealing with its contractors--to show contractors that the Government's rights cannot be treated as lightly as Weigand treated them. Instead, both cases were dropped for $25,000. Settlements of this sort, where issues of principle are compromised for token sums, demoralize those who work hard to support these principles. It is little wonder many Government employees become apathetic.

9. In my opinion, these two cases were not handled by either the Navy or the Justice Department in the best interests of the Government. The Justice Department erred by summarily settling this case without consulting those most familiar with the facts. The Navy erred in not following this case more closely. Under the circumstances, I recommend that the Navy take whatever action is possible to reopen these two cases in order that the issues of principle can be resolved. As a first step, the Navy should request the Attorney General to reconsider the action of the Justice Department in settling these two cases in the manner it did. I would appreciate being advised of the action that you intend to take in this regard.

H. G. Rickover

H. G. RICKOVER

Copy to:
COMNAVSHIPS
CNM
ASTSECNAV (I&L)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

May 10, 1971

MEMORANDUM FOR THE GENERAL COUNSEL OF THE NAVY

Subject: Shipbuilder Claims

1. At a meeting on March 23, 1971, we discussed the probiem of shipbuilder claims. I stated my concern that these claims had become a way of life in the shipbuilding industry; that shipbuilders are able to turn almost any contract into a cost-plus contract by simply submitting claims for change orders or for extra work beyond the requirements of the contract.

2. Subsequent to this meeting, the Deputy General Counsel sent me a copy of his July 22, 1969 memorandum which he had submitted to the Vice Chief of Naval Operations. In this memorandum he explained the position of the Office of General Counsel on shipbuilder claims. Also, I have reviewed General Accounting Office report of April 28, 1971, which criticized the Navy for not obtaining specific evidence to support shipbuilding claims settlements.

3. It is my opinion that neither the Navy nor the General Accounting Office has fully faced up to the claims problem, and that the Navy is not taking adequate or appropriate steps to exercise fiscal responsibility and to protect the government.

4. Here is the situation we face today as I see it:

a. Most of our major shipbuilding contracts are awarded sole-source or with only limited competition. Even in the recent SSN 688 class procurement where there was a fair degree of competion, the Navy is using incentive type contracts under which the Government assumes the major portion of the risk of cost overruns. In sum, there is little or no competition to keep prices down.

b. For many years shipbuilders have been operating on what is, in effect, a noncompetitive basis. There is, and has long been, no compulsion, no requirement for them to develop effective cost controls, procurement practices, or concern about the efficiency of their operations. Generally, the attitude in these shipyards is that costs cannot be controlled and they will end up to be whatever they turn out to be. Wasteful subcontracting practices,

inadequate cost controls, loafing, and production errors mean little to these contractors. They will make their profits whether the product is good or bad; whether the price is fair or whether it is higher than it should be; whether delivery is on time or late. Shipbuilders can let costs come out where they will and count on getting relief through changes and claims, relaxation of procurement regulations and laws, government loans, follow-on sole-source contracts, and other escape mechanisms. It necessarily follows that there is considerable inefficiency and waste in shipbuilding. In fact, current Department of Defense profit policies actually reward higher costs with higher profits and punish greater efficiency with lower profits.

c. Under current shipbuilding contracts the Government is highly vulnerable to claims. These contracts are built around detailed technical specifications which are necessary to assure essential military features. For various reasons, the Government itself furnishes many of the components and equipments which the shipbuilder is to install. The work extends over a long period of time, four to five years or more. Under these circumstances, changes are inevitable. Inevitably too, shipbuilders can find ambiguities or minor faults with specifications; the Government may be late in furnishing some of the components. A shipbuilder can always find some reason for increasing the price of the contract. Regardless of his inefficiency and no matter how high his costs, the shipbuilder can protect his profit by claims against the Government. In actual practice, the contract is binding on the Government alone, not on the shipbuilder.

d. Today many of our shipbuilders devote considerable efforts to establishing, early in their contracts, a basis for large claims to be submitted later. Some shipbuilders have set up sizeable permanent organizations whose sole purpose it is to develop claims against the Government. Every Government action is carefully screened to discover any possible basis for a claim. In some cases shipbuilders delay pricing of individual change orders in order to force negotiation of an overall settlement of several changes to which can be added large amounts of unsubstantiated costs for delay, disruption or other claims.

e. In preparing his claim, the shipbuilder assembles a team of experienced lawyers, accountants, and engineers—as many as are needed. The shipbuilder also engages the services of a law firm that specializes in prosecuting claims against the Government. The claims team develops a rationale for the claim and then puts together volumes of documents carefully selected to support the shipbuilder's contentions. The Government pays directly or in overhead as much as 90-98 percent of the shipbuilders' costs and expenses. Thus, the Government has placed itself into the position of paying almost the entire cost to the shipbuilder of making and prosecuting his claim against the Government.

f. In contrast to the shipbuilder's claims organization, the Government usually has but a small number of people knowledgeable in the details of the claim; fewer yet who are competent to defend against it. Government technical personnel can ill afford the time from their work that is required to analyze contractor claims thoroughly, to refute them or to separate valid from invalid claims. As a result most claims are being settled by bargaining, not by factual, legal or accounting determinations. In fact, many shipbuilders have made factual determination impossible, by simply not keeping adequate records. This, I believe, is why shipbuilders are adamant in refusing to maintain adequate accounting records which would show the actual costs of changes and of other work.

g. Once a claim is submitted, the shipbuilder and his claims lawyers press for a quick settlement, using their considerable influence in the Department of Defense, and threatening action before the Armed Services Board of Contract Appeals or the courts. Knowing that legal action to defend itself can consume years of effort by the few Government people available, who must meanwhile continue to handle their normal assignments, the Navy has been forced to resort to lump sum settlements and "handshake agreements" based on bargaining.

h. Since the shipbuilder knows his claim will be settled by bargaining on a lump sum basis, he is encouraged to exaggerate his claim so as to obtain as high a settlement as possible. As House Ways and Means Committee Chairman Mills once pointed out, industry negotiators sometimes plant a few Easter eggs in their proposals for Government negotiators to find. On finding them the latter score some points, but the farsighted contractor remains, as intended, ahead of the game.

5. To the extent shipbuilders get more than they should in claims settlements, the Navy is subsidizing inefficiency and undermining its own contracts. As long as shipbuilders know that the government will bail them out through changes and claims, it will be impossible to achieve effective cost control, improved efficiency, or lower costs.

6. Deputy Counsel's July 22, 1969 memorandum to the Vice Chief of Naval Operations stated his intent to put shipbuilder claims through a "legal wringer" to squeeze the water out of any that are not solid. This is essential. Any claim or part of a claim not solidly grounded in fact or in law, or not susceptible of factual determination should be disallowed. Items not clearly supported by factual records or not susceptible of factual determination should, if pursued by the shipbuilder, be settled by the courts, not by the Navy.

7. I realize that your office does not generate shipbuilding claims; that they arise out of actions by others. I also realize that it is not your job, but the job of others to eliminate practices which give rise to unfounded claims. It nevertheless appears to me that it devolves upon you as the Navy's legal officer to see to it that these claims are settled legally and properly, and without setting damaging precedent for the future. In this sense, your clients are the American public and those of us in the Navy who are charged with building ships at minimum cost. There always will be great pressures to settle claims quickly. These pressures militate against thorough review. The Navy, by failing to ensure adequate legal review has already set precedents damaging to future contracts.

8. In view of the above I recommend the following:

a. Government contracts should prohibit payment, directly or indirectly, of any costs associated with preparation or prosecution of claims against the Government. The Armed Services Procurement Regulation should be strengthened as necessary to implement this; and with no room for ambiguity, as is presently the case in many of its provisions.

b. Whenever it is necessary to augment its own resources for legal analysis and defense against claims of shipbuilders, the Office of General Counsel should obtain competent outside help—legal and technical. I understand that outside legal help was used in connection with the subsidence problem at the Long Beach Naval Shipyard. The use of outside legal firms to help the Government defend against claims would ease the burden on the small existing organization. It would serve to expedite the review and settlement process, and would provide for the thorough analysis required to settle claims on their merits.

c. The settlement of claims is principally a legal matter, not a contract negotiation. Therefore, the Office of General Counsel should establish a Review Board composed of qualified legal, accounting and technical experts to carefully review proposed claim settlements and to eliminate from them any items not clearly supported by factual determination of entitlement and amount. The elimination of unsubstantiated items from negotiated settlements would compel shipbuilders to keep proper records.

d. The Office of General Counsel should promulgate a list of contractors who frequently or repetitively make claims against the Government, or who submit excessive or unwarranted claims. Procuring agencies should give consideration to a contractor's claims record in awarding new contracts.

I believe the above steps would help to ensure that current claims are settled properly and that further degradation of the contractual relationship with our shipbuilders is avoided.

9. The Government and members of the shipbuilding industry have become mutually hostile groups in that the one desires a satisfactory product at a reasonable price while the other appears to desire the greatest price the traffic will bear. These antipathies will continue to the detriment of the shipbuilders and of the Government unless there is developed a self-disciplined manner of dealing with one another. What we need between these two hostile groups is the greatest courtesy and consideration. We need a moderation and mutual consideration in their behavior that is not evident today. Such mutual consideration cannot be achieved as long as these shipbuilders make it standard practice to use every possible stratagem against their Government: as long as they resort to dubious accounting practices; employ large number of lawyers and accountants whose sole objective is to prosecute claims against their Government; use the monopoly position and superior bargaining power they possess to take advantage of their Government's urgent needs by forcing costs as high as is possible. In short, operating on the basis that by these actions they have nothing to lose and everything to gain.

10. I know of no company that conducts its contracting business as loosely as the Navy does its shipbuilding. This loose way of doing business has now led to a situation where many officials of companies in overall charge of shipbuilding look on shipbuilding as a financial proposition, pure and simple. These officials hold their positions because of their financial acuity, their political contacts and ability to manipulate government contracts to their own advantage.

11. A degree of self-limitation is essential in all human behavior; a mutual self-limitation which represents tacit agreement on the rules of the game. This is essential to the survival of both business and Government and is within the bounds of practical possibility. This must be achieved as soon as possible.

H. G. Rickover

Copy to:
Secretary of the Navy
Assistant Secretary of the Navy (Installations and Logistics)
Assistant Secretary of the Navy (Financial Management)
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
OFFICE OF THE GENERAL COUNSEL
WASHINGTON, D. C. 20360

OGC/MHS:jl
28 May 1971

MEMORANDUM FOR VADM H. G. RICKOVER, USN

Subj: Shipbuilding Claims

Encl: (1) OGC Memorandum to Under SecNav dated 8 August 1969, Subj: Claims Under Contracts
(2) NAVMAT INSTRUCTION 4000.31 of 17 September 1970 Subj: Review of Technical Documentation and Related Contract Work Statements
(3) Navy Procurement Circular No. 18 dated 27 October 1970

1. In General. I have studied your memorandum of May 10, 1971, on shipbuilding claims with considerable interest, since I have been most concerned about the influx of huge claims against the Navy in recent years. As you know, I am retiring from the Navy. I would like, however, to give you and the information addresses some of my thoughts on the subject even though I realize that my successor may well have different views.

2. In view of the concern of members of the Navy Secretariat and other top officials of the Navy about the magnitude of the claims problem facing the Navy, I submitted a memorandum to the Under Secretary of the Navy dated 8 August 1969 in which I proposed ten basic approaches to help control the claims situation; (enclosure (1)). I realized then and I realize now that there is no panacea that will eliminate the claims problem entirely. I stated in this memorandum that the Chief of Naval Material concurred in each of these recommendations. I will outline the actions that the Chief of Naval Material and my office have taken to implement these ten recommendations.

3. Two years ago my office reviewed Navy claims over $1 million asserted under NAVSHIPS, NAVAIR, NAVORD and NAVELEX contracts. The causes or grounds for such claims were found to be: erroneous specifications and defective drawings, contractual directions from persons other than the contracting officer, contract misinterpretations, delay, acceleration and erroneous rejection of tendered work. Since nearly one-fourth of the claim dollars were attributed to defective Government-furnished specifications and drawings, Navy corrective efforts were directed first toward improving our technical data packages and our contract administration.

4. Contractual Improvements. By two programs the Navy has acted to improve the quality of technical data -- both specifications and engineering drawings -- furnished to contractors. In one, procuring activities have sponsored courses to train technical and engineering personnel in good specification drafting. The objectives here have been not just clarity and accuracy, but harmony with other specifications and with DOD policies. NAVSHIPS and NAVSEC are among the activities which have held several of these courses.

5. Second, NAVMAT has promoted the use of a specification review procedure designed to require a hard pre-contract look at the adequacy of the specifications to be used and to mate their assessed risks of success with appropriate contractual risk (see enclosure (2)). Concurrently, the Navy has sought to expand its practice of "in-process verification and review" of technical data -- principally engineering drawings. A problem of long standing is that good drawings have not -- and cannot -- be assured only through inspection upon delivery, and many of our claims problems from successor contractors have resulted because we failed to give equal attention to the developer's production of both the hardware and the software. "In-process verification" can add immeasurably to the quality of the drawings and other data which are passed on by the Government to a new manufacturer or builder.

6. In furnishing technical data to a new source, we have also sought to be more realistic in apportioning the risks of its adequacy to do the intended job. NAVMAT has promulgated methods whereunder the contractor assumes the financial burden of all "patent" defects in the data package discoverable upon a pre-bid examination and the Government agrees to treat and price as changes all "latent" errors of which the parties are unaware. As a corollary, though, in instances where the data package being provided was initially developed by the production contractor and has not been materially altered by the Government, the Navy has insisted on a "total system responsibility" clause under which the full risk of deficiencies lies with the contractor.

7. Contract Administration Improvements. In Navy Procurement Circular No. 18 (enclosure (3)), NAVMAT published for trial use a number of contract clauses intended to reach the sources of claims found to arise out of the Government's administration of a contract during performance. They were preceded by similar clauses in NPC No. 15. I will review the purposes of a few of them:

8. "Changes" Clause. The new "Changes" clause was developed to require contractors to give prompt notice of impending or actual constructive changes, thus affording the Navy the opportunity (i) to evaluate the impact and desirability of an impending constructive change; (ii) to confirm or deny

that our act or failure to act constitutes a constructive change; (iii) to direct the fashion of further performance; (iv) to countermand actions which could result in an unwanted constructive change; and (v) to plan for funding and pricing.

9. "Problem Identification Reports" clause. The NPC 18 "Changes" provision should induce a conscientious contractor to report most potential performance problems to the Navy as they first arise. If that Changes clause isn't used, or if performance problems not covered by that clause arise, the Navy obtains such information by this second clause. Further, as you note, one of the most troublesome aspects of shipbuilding claims is the contractors' frequent practice of submitting multimillion dollar constructive change claims months or even years after the fact. Both of the foregoing clauses were drafted to stimulate prompt submission of such claims: the stimulus is a clause phrase which has the effect of diminishing the quantum of equitable adjustments by disallowing claim costs incurred more than 20 days prior to the contractor's submission of the notice or report.

10. "Change Order Accounting" clause. In May of 1969 you testified to the Subcommittee on Economy in the Government to the effect that contractors do not adequately and individually account for change orders, with the result that it is frequently impossible to establish the cost of individual changes. Your testimony led my office to draft this clause, which requires a contractor, for significant changes, to maintain separate accounts for segregable direct change order costs.

11. "Change Order Estimates" clause. To promote forward pricing of changes wherever possible, this provision makes a contractor's engineering change proposal a firm offer acceptable by the Navy for sixty days. The Navy, of course, can seek to negotiate a lower price if the contractor's proposed price is found unreasonable.

12. "Waiver and Release of Claims" clause. Once having equitably adjusted a change, the Navy desires no further claims stemming from that change, but should have a full and final settlement of the transaction. This clause provides a full and final release.

13. In addition to contractual steps, NAVMAT and my Office have also given considerable emphasis to a saturation training program in contract administration. A five-week course has been given to the seven SUPSHIP and NAVPRO offices where the bulk of Navy procurement dollars are administered, with nearly two dozen more scheduled during the next fiscal year. Further, my office has prepared and presented a seminar on change claims to 37 audiences of more than 3000 Navy personnel.

These presentations stress the methods for avoiding constructive changes and for handling such claims when they arise. They, too, will continue to be presented in the coming fiscal year.

14. Handling Claims. I feel that the steps I have just described will help us to catch up with the business and economic times in which contractors seem to be leaving no stone unturned in their quest for every recoverable dollar under our contracts. I certainly recognize that none of these programs or procedures will make a dent in the problem without the people to carry them out. As often seems to be the case, adequate staffing is hard to come by in the Navy, but I strongly believe these efforts are headed in the right direction and deserve every support that will lend to their success. Also, I recognize that despite all our best efforts and intentions, humans will err and claims will arise. In one shape or another they have always been with us, and I suspect they always will be. The final question, then, is how best to handle those that we have and will continue to receive.

15. I have consistently advocated that the claims team should exhaustively review, analyze, evaluate and document both the fact and quantum of contractor entitlement before negotiation and resolution of any claim. The Navy Secretariat, the Chief of Naval Material and the Commander, NAVSHIPS have endorsed this policy, which includes the following features:

a. Claims should be settled by negotiation if at all possible. Our contract provisions require as much.

b. The Navy should use a "team approach" to claims settlement -- the engineer, production expert, auditor, negotiator, and lawyer each contributing his special expertise.

c. The lawyer should participate not simply in establishing the Government's liability but also in weighing the factual support for determining the quantum of relief to which the contractor may be entitled.

16. The premise of this procedure is that such claims should be settled by negotiation to the extent possible, first establishing a Government negotiation baseline from close analysis of factual, technical, audit and legal entitlement on each individual element of the claim. The typical "massive claim" is fundamentally an amalgam of hundreds of formal or constructive changes made to the terms of the original contract -- whether for delay costs arising out of late GFM or for defective technical data -- and thus it is actually a gigantic request for equitable adjustment in price or schedule under the terms of the contract "Changes" clause. Whether for tactical or for practical, unavoidable reasons such requests in the past have

been permitted by the contractor to accumulate until their ultimate presentation to the Navy in one overwhelming formal package, sometimes even years after the events concerned. They must be disassembled, analyzed, tested, and evaluated piece by piece, and that is a job demanding a complete negotiation team.

17. While I fully acknowledge that the lawyers must carry a share of the burden in claims settlements which may far exceed their participation in initial contract negotiation, I believe the settlement itself should continue to be conceived and treated as a negotiation within the constraints that our evaluation of the facts and law impose. In a recent speech, Deputy General Counsel Stein summarized the lawyer's role this way:

> "Three determinations must ordinarily be made with respect to a claim. It must be determined that if certain facts exist, there is a basis for Government liability. Second, it must be determined that those facts exist in the instant case. Finally, the extent of the damage attributable to the Government must be determined. As lawyers, we can claim virtually full responsibility for the first determination. The second two determinations must be made in concert with other members of the negotiating team, and, as to them, we claim only the right to participate in the determination; not the right to make the determination.
>
> "The principal friction seems to come in the area of documenting the claim. The documentation may relate to whether the conditions that would give rise to Government liability have in fact occurred, or it may relate to the extent of the damage attributable to that cause. To some, this appears to be a pricing action that non-lawyers are capable of handling as they handle other pricing actions.
>
> "But there is a basic difference between pricing claims and pricing contract articles. When we pay this type of claim, we are not buying something, we are paying damages, by whatever name we call them. To do that with reasonable confidence in the results, we must anticipate what a court or Board would allow the contractor if the matter were adjudicated in a judicial forum. That in turn requires us to have an understanding of the evidence on which the claims depend, both for the determination of legal entitlement and for the determination of the quantum. And evidence is a subject that lawyers ought to know something about."

18. Comments on your Four Specific Recommendations. With specific reference to the recommendations in paragraph 8 of your memorandum, I have the following comments:

a. I am directing the Navy legal member of the ASPR Committee to ask the ASPR Committee to consider the question of the allowability of costs associated with preparation and assertion of claims against the Government.

b. The use of outside legal assistance in the Long Beach subsidence case affords no precedent for the use of such assistance in the daily investigation and resolution of the Navy's chronic change order claims. In the subsidence case, the Government's case was presented by the Justice Department, not the Navy, and Justice determined to augment its legal expertise with the aid of three California lawyers. I consider that it is preferable that we develop and maintain an in-house capacity in OGC to perform the necessary legal analysis and defense against shipbuilding claims. We have increased our staff in the Naval Ship Systems Command to do this, and further increases may be necessary.

c. I agree, as stated above, that major claims should be reviewed by a group of qualified procurement, legal, accounting, and technical experts. The Contract Claims Control and Surveillance Group would appear to have these qualifications and although it is too early to evaluate its performance, I am hopeful that it will serve the intended purpose. A similar board in the Office of the General Counsel would seem to me to be an unnecessary duplication. Also, there is the requirement that claims settlements over $5,000,000 must be approved by the Assistant Secretary of the Navy (I&L).

d. The Navy maintains an Experience List of contractors who present special procurement problems. I do not believe that a contractor could, or should, properly be placed on this list merely because it makes frequent or repetitive claims. It would constitute an unjustifiable penalty to place upon a company which has done no more than to assert its contractual rights. There would be some merit in the concept of warning our procuring activities of those contractors which have repeatedly submitted unwarranted, invalid or grossly excessive claims, as a matter bearing upon any future finding of their responsibility and business integrity.

Meritt H. Steger
General Counsel

Copy to: SecNav
Under SecNav
ASN(I&L)
ASN(FM)
CNO
CNM
Counsel, NavShips
COMNAVSHIPS
Mr. Charles Ill

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D C 20360

IN REPLY REFER TO

11 FEB 1972

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subject: Claims Procedures

Reference: (a) NAVMAT NOTICE 4200 dtd 11 Jan 1972
(b) My memorandum for the General Counsel of the Navy dtd May 10, 1971 subj: Shipbuilder Claims

1. I have just learned of the new procedures established by reference (a) for handling contractor claims against the Navy. I am concerned because these new procedures appear to be a step in the wrong direction, particularly for the large complex shipbuilding claims we are encountering today.

2. The new procedures provide for settlement of contract claims at the "lowest possible level in the contracting framework." Claims of $10 million or more are subject to review by a General Board consisting of selected senior flag officers in the Naval Material Command and the Office of the Chief of Naval Operations. This General Board is to be assisted by a Claims Board composed of "procurement executives" designated by COMNAVSHIPS, COMNAVAIR, COMNAVORD and COMNAVELEX. Presumably, assignment to the Claims Board is in addition to each procurement executive's normal full-time job. Reference (a) further provides that a Navy Deputy General Counsel will be an adviser to but not a member of the Claims Board.

3. I consider a number of things to be wrong with this approach.

a. First, the new procedures make claims settlements a routine contract matter. Yet these claims, by their very nature, go beyond routine contract actions and therefore should be accorded special handling. Routine settlement of claims as an ordinary contracting matter will encourage more claims and will tend to undermine our contractual relations.

b. These claims usually involve complex questions of fact and of law; to properly resolve these matters requires both special expertise and legal training. My experience over a period of many years is that most Navy contracting officers and procurement executives are not adequately trained or experienced to analyze and settle these large claims. Further, few flag officers possess the training, background, experience and judgment to deal with such claims; even fewer have the time to do so.

c. The settlement of claims, particularly large complex claims against the Government is principally a legal matter, not a contract negotiation. The Navy should not pay any claim or part of a claim that is not solidly grounded in fact or in law. Any claim not susceptible of factual determination should be rejected. Items not clearly supported by factual records or not susceptible of factual determination should, if pressed by contractors, be settled by the courts, not by the Navy.

4. In reference (b) I pointed out that our contractors are exerting considerable effort to establish, early in their contracts, claims against the Government. Some contractors have set up large organizations with experienced lawyers, accountants and engineers — as many as are needed — to develop claims against the Government. Often, they also engage outside claims experts in the legal profession to guide and assist them. The Government has no comparable body of talent to defend itself against these claims.

5. In reference (b) I also pointed out that to the extent contractors get more than they should in claims settlements, the Navy is not only subsidizing inefficiency but also undermining its own contracts. As long as contractors believe that the Government will bail them out through changes and claims, it will not be possible to achieve effective cost control, efficiency, or lower costs.

6. I would like to reiterate my recommendations in reference (b) for handling major claims against the Government:

a. I would assign primary responsibility to the Office of the General Counsel.

b. The Office of General Counsel should establish a Review Board composed of qualified legal, accounting and technical experts to carefully review proposed claim settlements and to eliminate from them any items not clearly supported by factual determination of entitlement and amount. The elimination of unsubstantiated items from negotiated settlements would compel contractors to keep proper records.

c. Whenever it is necessary to augment its own resources for legal analysis and defense against contractor claims, the Office of General Counsel should obtain competent outside help — legal and technical. The use of outside legal firms to help the Government defend against claims would ease the burden on the small existing organizations. It would serve to expedite the review and settlement process, and would provide for the thorough analysis required to settle claims on their merits.

d. Government contracts should prohibit payment, directly or indirectly, of any costs associated with preparation or prosecution of claims against the Government. The Armed Services Procurement Regulation should be strengthened as necessary to implement this; and with no room for ambiguity, as is presently the case in many of its provisions.

e. The Office of General Counsel should promulgate a list of contractors who frequently or repetitively make claims against the Government, or who submit excessive or unwarranted claims. Procurement agencies should give consideration to a contractor's claims record in awarding new contracts.

7. I know of your strong desire to improve Navy procurement. I trust you will give full consideration to my recommendations. We must have procedures that will ensure that all claim settlements are adequately supported, factually and legally.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
General Counsel of the Navy
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

17 MAY 1972

Mr. N. J. Marandino, President
Ingalls Nuclear Shipbuilding Division
Litton Systems Incorporated
P. O. Box 149
Pascagoula, Mississippi 39567

Dear Mr. Marandino:

In our meeting of 18 April 1972, I pointed out that, based on NAVSHIPS' review, the contract price adjustment requested by Ingalls for extension of contract delivery and alleged late delivery of Government furnished materials on the SSN 680, 682 and 683 contract appears grossly excessive. Ingalls' proposal grew from about $6 million in 1969 to about $48 million as of 11 April 1972. In addition, supporting data presented by Ingalls in response to Navy requests have often been extraneous, ambiguous and unsupportive of the Ingalls' proposal. That is why during our meeting I asked that you take another look at the Ingalls' position and certify that the data and costs presented in support of this position, or as it might be revised by you, were accurate. You agreed to do so.

Your 1 May 1972 letter indicates that you reviewed Ingalls' position and are willing to reduce Ingalls' ceiling price proposal by $25 million, contingent on the Navy's acceptance of terms by 31 May 1972. However, you did not identify where cuts were made, nor did you certify the accuracy of the supporting data as you had agreed. Therefore, it is impossible for the Navy to evaluate the 1 May 1972 proposal or to relate it to prior Ingalls' proposals and supporting data.

I am told that because of the change you proposed in escalation payments, the actual concession offered by Ingalls in real dollars is substantially less than the $25 million indicated. However, in the absence of accurate and reliable supporting data, such arbitrary reductions, regardless of the amount, do not help the Navy determine an equitable contract adjustment. To proceed on the basis of your proposal, would in effect be "horsetrading."

I agree with you that it has already taken too long to settle this matter; it appears no agreement is yet in sight. However, Ingalls must bear responsibility for much of the delay. To date NAVSHIPS has not been able to obtain from Ingalls accurate and reliable supporting information necessary to make a factual determination of any amounts due. By enlarging its claim, or elements of the claim, Ingalls has made the problem of evaluating its requests unnecessarily difficult.

The Navy wants to resolve this matter as quickly as you do. To do so, however, will require Ingalls' full cooperation. If there is a real interest on Ingalls' part to settle this issue quickly and on an equitable basis, you should act promptly. You should provide appropriate documentation to back up your proposal and certify the data as to its accuracy as you previously agreed at our 18 April 1972 meeting.

I would appreciate your reply by 31 May 1972.

Sincerely,

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Material
Commander, Naval Ship Systems Command
Deputy Commander for Contracts (SHIPS 02)
Supervisor of Shipbuilding, Pascagoula

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-545
30 JUN 1972

MEMORANDUM FOR THE DEPUTY COMMANDER FOR CONTRACTS, NAVAL SHIP SYSTEMS COMMAND

Subj: Ingalls Nuclear Shipbuilding Division, Litton Systems, Incorporated, claim against the Navy under Contract N00024-68-C-0342 for construction of SSN 680, 682, and 683

Encl: (1) Summary of Navy Technical Evaluation of Litton Systems, Incorporated, Claim on SSN 680, 682, and 683 Contract
(2) Summary of Changes in Litton Systems, Incorporated, Claim on SSN 680, 682, and 683 Contract

1. For the past 19 months, NAVSHIPS has been attempting to evaluate various claims for a price adjustment submitted by Ingalls Nuclear Shipbuilding Division of Litton Systems, Incorporated, under the subject contract. The purpose of this memorandum is to summarize the results of these technical evaluations and to recommend a course of action to settle the claim. Enclosure (1) contains additional details concerning the technical evaluations.

2. Litton's claim for contract price adjustment is based on the following:

a. Shortly after contract award in June 1968, NAVSHIPS extended contract delivery dates for the three Litton submarines by 11-1/2 months. This was done to provide an appropriate interval between the ships and the lead ship being built by another shipbuilder, and to schedule construction of the ships so as to accommodate expected delivery of Government-furnished materials.

b. Litton claims six months additional delay (beyond the 11-1/2 months) and disruption which it alleges was caused by late delivery of Government-furnished hull steel.

3. In 1969, NAVSHIPS and Litton reached agreement on a target price increase of about $6.2 million for the 11-1/2 month delivery extension. NAVSHIPS considered this increase acceptable and requested the Chief of Naval Material to approve the agreement. The Chief of Naval Material, however, rejected the settlement and, in December 1969, Litton withdrew its proposal.

4. Since December 1969, Litton has submitted five different proposals on this claim:

a. The first of these proposals was received in November 1970; it totaled about $40 million. In this proposal Litton claimed substantial additional sums for costs due to alleged impact of late Government-furnished steel, loss of learning, loss of productivity, function-of-time tasks, additional escalation, and other items.

b. The second proposal, in February 1971, increased the claim to $43.5 million.

c. The third proposal, in December 1971, reduced it to $40.1 million.

d. The fourth proposal, in April 1972, increased it to $42.8 million.

e. The fifth proposal, in May 1972, decreased it to $37 million, where it stands today.

Although the total amount of the claim has remained relatively constant since November 1970 ($37 to $43 million), the elements of the claim have changed substantially (see enclosure (2)).

5. There are indications that Litton has "backed into" its claim figure. The various claim proposals have been roughly equal to Litton's projected overrun. If Litton's present claim were allowed in full, it would turn a substantial loss under the contract into a substantial profit. In fact, Litton would obtain a higher profit than the initial target profit allowed in the contract. The major part of the claim consists of assertions, judgments, and allegations -- unsupported by factual backup data. To overcome the lack of factual data supporting its claim, Litton has resorted to theoretical calculations and to what appears to be specious reasoning. From this, the NAVSHIPS technical review team was led to question Litton's good faith in its calculations of costs for the Government-responsible delay. It appears that Litton set out to obtain about $37 to $43 million from the Navy and developed its claim around those predetermined figures.

6. It appears, as detailed in enclosure (1), that only $4 to $7 million of the claim is, in fact, justified. Our specific conclusions concerning the claim are as follows:

a. The Navy does owe Litton for the 11-1/2 month delivery extension, but not for the extra six months delay Litton claims was caused by late delivery of Government-furnished steel. Under the contract, the Government was required to provide steel in time to meet ship contract delivery dates. Our evaluation shows that all steel was actually on hand at the shipyard in ample time to support the 11-1/2 month extended ship delivery schedules. In fact, all steel was on hand by March 1969 — the end date for steel deliveries as specified in Litton's bid for the <u>original</u> ship delivery schedules.

b. The "loss of learning" argument, upon which Litton bases the largest portion of its claim, is unsupportable, factually and theoretically. Litton could not substantiate how much "learning," if any, was included in its initial bid. There is no valid basis for the "loss of learning" calculation in Litton's claim.

c. Litton has grossly exaggerated its claim for "function-of-time" costs — costs which increase as the period of construction increases. Claimed costs in this area appear to be overstated by a factor of four.

d. In April 1972, the Navy asked Litton management (Mr. Marandino, the President of Ingalls Nuclear Shipbuilding Division) to review and certify its claim. As a result of this request, Litton deleted items totaling several million dollars. As an offset to these deletions, however, Litton substituted a new item totaling $4.6 million for "uncollectible escalation" on contract labor costs. This $4.6 million item, in effect shifts to the Government the escalation costs growing out of contractor-responsible delays and overruns.

7. The largest part of Litton's cost overrun appears to be due to Litton's mismanagement of the contract and to the over-optimism in its initial bid. The NAVSHIPS technical review team found case after case of mismanagement. In addition, Litton priced the contract well below the bids of its competitors. Today, Litton's own estimates show that the company would have had to reduce costs about 11 percent over its previous cost experience on other submarines in order to avoid an overrun on this contract. Instead, Litton's actions tended to increase its costs. For example:

a. Litton's schedules for accomplishment of work prior to keel laying were unrealistic. Instead of scheduling work to accommodate expected steel deliveries and the agreed upon 11-1/2 month delivery extension, Litton, in fact, accelerated its schedule. This accelerated schedule ignored information available regarding projected deliveries of key items of Government-furnished materials as well as Litton-furnished material. It also ignored shortages of qualified workers in critical trades.

b. Litton failed to maintain adequate management control and surveillance of subcontract work.

c. Litton experienced excessive rework because of poor control of work in its shops and on the waterfront.

8. Litton claims that late delivery of Government-furnished steel delayed ship construction. The fact is that steel work on the two pacing sections for the SSN 680 were completed within 3 days and 21 days, respectively, of Litton's actual scheduled dates. The subsequent delays in completing these pacing sections occurred because Litton failed to obtain shielding materials in time to prevent schedule disruption.

9. Litton also claims that late Government steel delayed delivery of critical hull sections which Litton had subcontracted to Canadian Vickers. The technical review team found, however, that the delay in delivery of completed hull sections was Litton's responsibility, not the Government's. For example:

a. Litton promised to deliver steel to Canadian Vickers before Litton itself was actually scheduled to receive it and earlier than Litton itself had requested it from the Navy. Many templates furnished to Canadian Vickers were of improper dimension and required rework, or were not made available and had to be lofted and manufactured by Canadian Vickers itself.

b. Many steel plates formed by Litton and supplied to Canadian Vickers were of improper dimension or configuration, thus required reforming. Other plates arrived damaged or heavily scratched and had to be repaired.

c. Litton supplied various fitting and frame jigs which had to be reworked because the plates were cut too short.

d. More important, Litton took nearly ten months to resolve an ultrasonic testing problem at the subcontractor's plant. During this time, some completed hull sections waited up to four months to be tested, and then waited an additional two months to be shipped after final testing.

10. Another factor must be considered in connection with this claim: In January 1970, Litton requested NAVSHIPS' approval of a contract deviation as a result of its failure to procure certain materials to contract specifications. To correct the deficiency would have substantially increased Litton's costs and delayed delivery of each of the three ships about 12 months beyond the 11-1/2 month extended schedule. Because the Navy did not wish to further delay delivery of these ships, the Litton request was reluctantly approved. Had the Navy not agreed to accept this non-conforming material, Litton would have been responsible for an additional 12 month delay. This delay would have more than offset the alleged Government-responsible delay in furnishing hull steel.

11. Litton's poor management was not confined to the SSN 680, 682, and 683 contract. Litton has also experienced substantial delays and cost overruns on its other ship construction contracts. Specifically:

a. Nearly every Navy shipbuilding contract (SSN 680, 682, and 683 AE 32-35, LHA) with Litton is behind schedule and overrunning in cost. Moreover, Litton has large claims pending against the Government on all of these contracts. The only exception to date is the DD963 class shipbuilding contract where work has barely started.

b. The General Accounting Office (GAO) recently reported that Litton's poor procurement practices were causing unnecessary additional costs. The GAO conclusions grew out of a specific review of subcontracts placed under the SSN 680, 682, and 683 contract.

c. The Maritime Administration has also reported extensive problems in Litton's construction of Farrell and American President Line ships.

In December 1970, Litton Corporation changed management of its Ingalls yard. Since then there has been some recovery of the delays experienced on the SSN 680, 682, and 683 contract, but the ships are still about four months late to the 11-1/2 month extension schedule. There have also been extensive management changes in Litton's West Bank yard.

12. The Navy's evaluation of this claim has been a Sisyphean task. Each time Navy personnel gathered facts tending to invalidate items of Litton's claim, Litton dropped these items and substituted others. Because of this, Government engineers and administrative personnel had to spend thousands of hours attempting to properly evaluate the claim. The difficulty in obtaining substantiating data; Litton's exaggeration of costs; the continuing substitution of items in the claim; and the obvious effort to obtain a contract settlement substantially higher than warranted by the facts -- all have contributed substantially to the effort and time required for NAVSHIPS to arrive at a proper evaluation. This effort has taken the time and attention of key Navy personnel from their primary duties and has added considerably to the cost of administering Litton contracts.

13. The Navy pays a heavy price for dealing with Litton because of claims for changes and extra work. Litton's prices for contract changes on submarine construction have been nearly twice as much as those for the same changes at Electric Boat. (This will be discussed in a separate memorandum which points out that Litton's prices for changes on new construction submarine contracts have been as high as four times those of other private shipyards.) Even under cost-type overhaul contracts, Litton's claims for changes and extra work are excessive. For example, Litton's contract prices for overhauling the GUARDFISH (SSN 612) and the GREENLING (SSN 614) increased by 32 and 27 percent respectively as the result of changes and claims. These percentage increases are almost twice those experienced at Electric Boat and Newport News for comparable overhaul work.

14. In view of its experience, the Navy should reevaluate its relationship with Litton. To this end it is recommended:

a. Litton be offered a settlement of this claim within the $4 to $7 million range discussed in enclosure (2) and be given a reasonable period -- not more than 30 days -- to accept or reject the Government's offer. Any NAVSHIPS action to adjust the billing base for progress payment purposes should be contingent on acceptance of the Navy offer.

b. Should Litton choose not to accept the offered settlement within this 30-day period, or reject it, the contracting officer should issue a formal decision denying the excessive portion of the claim. If Litton then decides to pursue the rejected portion of the claim, this should be as a contract dispute before the Armed Services Board of Contract Appeals or, finally, in the courts.

c. No provisional payments or progress payments beyond those presently provided for in the contract should be made until this matter is settled.

d. Litton should not be considered for any future naval ship construction awards until this matter is settled and until Litton and the Navy reach agreement on a new business relationship -- one that does not rest on over-priced changes and excessive claims to "bail out" Litton contracts. If over-priced changes and claims are to remain an inherent part of Litton's relationship with the Navy, we have no business doing business with Litton.

R. K. Reed
Captain, USN
Project Manager
Submarine Ship Acquisition Project

H. G. Rickover
Vice Admiral, USN
Deputy Commander
Nuclear Power Directorate

Additional Comments by VADM Rickover:

The situation in which we find ourselves with Litton is endemic in Navy shipbuilding contracts. We have permitted ourselves to become enmeshed in a situation which has subtly and gradually eroded the proper, legal, and customary relationship with our contractors. We no longer have a true contractual relationship with shipbuilders; we have become their custodian and have assumed responsibility for their welfare. In essence we have no real contracts -- no true meeting of minds.

Economist Alfred Marshall once said, "...that in the trade which had got bounty or in other trades which hope to get one, people would divert their energies from managing their own business to managing those persons who control the bounties." (Emphasis mine) This is exactly the situation we face today in the shipbuilding industry. In shipyard after shipyard, I find top management paying little attention to the conduct of their business. Instead, their energies are devoted to seeing how much additional money they can get from the Navy and other customers. It does not matter how inefficient their yards become; they do not appear to care. They do not care whether the work is good or bad, on time or late, as long as they make a profit. Nor does it matter if their costs overrun; as things are today, they will recover their costs by making a claim against the Navy. As long as the Navy is willing to put up with exorbitant claims and keep inefficient contractors in business, Navy work at shipyards will not be well managed.

If the Navy permits this relationship to continue, we will not be able to buy the ships we need,no matter what sums Congress appropriates. We must become alive to the fact that Congress and the public are rapidly losing confidence in the Navy because of our way of doing business,and this bodes ill for our future. I urge, as I have many times in the past, that the present issue with Litton be promptly disposed of in a fair manner, as set forth above. Should Litton be unwilling to accept such a settlement, it should be handled as a legal dispute to be settled by the Armed Services Board of Contract Appeals or by the courts.

Summary of Navy Technical Evaluation of Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, claim against the Navy under Contract N00024-68-C-0342 for construction of SSN's 680, 682 and 683

1. Background.

On 25 June 1968, following competitive negotiations, the Navy awarded FY 1967/1968 submarine shipbuilding contracts as follows:

a. Three ships (SSN's 678, 679 and 681) to Electric Boat Division, General Dynamics Corporation. Subsequently NAVSHIPS exercised its option for a fourth ship (SSN 684).

b. Three ships (SSN's 680, 682 and 683) to Ingalls Nuclear Shipbuilding Division, Litton Systems, Inc., under Contract N00024-68-C-0342. Competitive proposals were obtained for a six ship award. Both Litton and General Dynamics bid to construct the first three ships of the class (General Dynamics bid to construct all six). At the time of contract award, NAVSHIPS entered into an agreement with Litton whereby the Navy could extend the delivery dates of SSN's 680, 682, and 683 by 11-1/2 months subject to an equitable adjustment in contract price. These arrangements were made so that:

(1) There would be a suitable interval between the lead ship to be built by Electric Boat (the lead design shipyard) and the follow ships to be built by Litton, and

(2) There would be a proper interval on follow ships so as to accommodate expected delivery of Government-furnished materials.

Litton was requested to submit its most economical proposal for extending the delivery dates. In July 1969, after protracted discussions of various propositions, NAVSHIPS requested NAVMAT approval of a Litton proposal to

settle on a target price increase of about $6.2 million for the 11-1/2 month delay. NAVMAT rejected this settlement and, in December 1969, Litton withdrew its proposal.

In July 1970, Modification P005 was issued to extend formally the contract delivery dates by 11-1/2 months. In November 1970, Litton submitted a greatly increased price proposal calling for a 17-1/2 month extension of contract delivery dates instead of the 11-1/2 month extension originally requested by the Navy. The extra delay was attributed to the "damaging effects of late GFE" -- primarily steel. Litton subsequently revised this proposal four times. Litton's most recent proposal, dated 1 May 1972, is summarized below:

	Original Contract Amount	Claimed Increase	Proposed Total
Target Cost	$100,444,000	$27,491,000	$127,935,000
Target Profit	6,973,000	3,084,000	10,057,000
Target Price	107,417,000	30,575,000	137,992,000
Ceiling Price	116,400,000	23,637,000	140,037,000
Share Ratio	60/40 above target 80/20 below target	No change No change	
Projected Escalation	$ 10,544,000	$ 6,387,000	$ 16,931,000

Litton has proposed a change to the contract escalation tables that would increase its recoverable escalation by approximately $6.4 million. The additional cost to the Government for the increase in target price and escalation, therefore, is about $37 million. The NAVSHIPS technical analysis of this claim is summarized in the following sections.

2. Summary of NAVSHIPS Technical Evaluation.

Litton claims that the Navy, by extending delivery of SSN's 680, 682 and 683, caused Litton to lose the benefit of learning curve efficiencies that it would have otherwise realized. It is also claimed that late delivery

of Government-furnished steel caused further delay and disruption by extending ship deliveries a total of 17-1/2 months, six months more than the 11-1/2 month extension desired by the Navy, with attendant increases in ship construction cost. On this basis, Litton has requested a contract price adjustment totaling about $37 million.

The Navy has never sought to avoid its liability for extending the ship contract delivery dates 11-1/2 months. The problem is to determine what impact this extension had on Litton's costs and to what extent the Navy might be liable for further contract price adjustment due to other reasons claimed by Litton, such as late delivery of Government-furnished steel.

The NAVSHIPS technical review team has made an extensive review of the various Litton claim proposals and backup data. The task was extremely difficult because, in most cases, Litton did not have records or backup data to support its claim. Most of the claim consists of allegations, judgments, and postulates without factual support. Moreover, the contractor frequently revised its claim proposal, substituting new allegations for ones that were questioned in the Government's fact finding sessions. Thus, while resolution of this claim has dragged on for many months, Litton must bear responsibility for much of the delay.

The following is an explanation of the major factors in the Litton claim, and NAVSHIPS' technical evaluation of them. Detailed comments on each element of Litton's claim proposal have been provided separately.

Delay due to Alleged Late Delivery of Government-Furnished Steel

Litton claims that late delivery of Government-furnished steel delayed ship construction six months beyond the 11-1/2 month contract delivery date

extension directed by the Navy. Specifically, Litton claims that certain hull sections which paced the ship construction schedules were delayed up to six months, and, consequently, the ships were delayed a like amount. Litton states that failure to complete the hull sections surrounding the SSN 680 reactor compartment (bulkheads 56/57 and bulkhead 65) on time, was the major factor delaying ship construction. The review team agrees with this assessment. The delay, however, was not the result of late Government-furnished steel, as Litton has asserted.

Under the contract, NAVSHIPS was obligated to provide Government-furnished hull steel in time to meet ship contract delivery dates. NAVSHIPS did not provide all Government-furnished steel on the dates Litton requested. However, all steel was on hand at the shipyard in ample time to support the extended ship delivery schedules. In fact, all steel was on hand by March 1969 -- the end date for steel deliveries specified for the original ship delivery schedules in Litton's bid.

In its contract proposal, Litton requested delivery of all Government-furnished hull steel during the period June 1968 to March 1969 to support delivery of the first ship in September 1971. The September 1971 delivery date correlates with the delivery schedule for the first ship (SSN 678) of the six ship award. However, the Navy decided to award SSN's 678, 679 and 681 to Electric Boat; Litton was assigned the third, fifth and sixth ship (SSN's 680, 682 and 683). Accordingly, the Litton delivery dates were extended by 11-1/2 months to provide a proper sequence for these follow-on ships.

The Navy had advised all bidders in January and again in June 1968 of Government-furnished hull steel delivery information. This information showed that delivery of hull steel for the first of the six ships would begin

in June 1968 and that deliveries for follow ships would commence at two month intervals. Thus, at the time it signed the contract and agreed to extend ship deliveries, Litton was well aware of the Navy's schedule for delivery of hull steel: Delivery of steel for SSN 680 was to commence in October 1968.

Following award of the SSN 680, 682 and 683 contract and negotiation of the agreement providing for an 11-1/2 month delivery extension, Litton personnel began to request that Government-furnished hull steel be furnished on or before dates earlier than those contained in the Navy schedules for SSN 680. The dates were, in fact, even earlier than the dates reflected in the Litton contract proposal. Specifically, in July 1968, Litton asked for delivery of all Government-furnished steel for SSN 680 not later than August 1968. The Navy could not comply with that request and Litton was so advised.

In August 1968, Litton again requested all hull steel for SSN 680 that month — well ahead of scheduled delivery dates which were to begin in October 1968.

At the time, Litton's reasons for persisting in its requests for Government-furnished steel earlier than the Navy scheduled dates were not entirely clear. Litton lacked trained personnel to work the steel, had it been delivered as the company requested. The situation is described in a letter signed by the President of Ingalls Nuclear Shipbuilding in March 1969:

> "For several skills in our shipyard it takes years to train a qualified worker. It is difficult to find people who can qualify to do HY80 hull work on submarines. In any event, it takes time. Much more time than we had starting last summer when we learned that we had won the contract for three new submarines. And this in spite of all the effort humanly possible to enlarge and accelerate our training programs.

"One thing became extremely clear to us in recent months. No matter how we tried to rearrange our schedules, we were going to have to lay off as many as 500 people (in crafts other than the hull crafts) before the end of this year, unless, somehow we could 'get over the hump' in the hull shipfitting and welding work.

"It makes sense, if we were to purchase services outside to get us over the shipfitting and welding 'hump' to purchase the services where we have the tightest problem in hiring and training people.

"The main problem, of course, was the long dry spell between the time we last won a submarine contract in 1963 and this past year when we finally won these three. This long gap caused us to 'break our stride.' Had we received a submarine contract in 1965, the hull work would by now have been far enough along so that outfitting people moving off 'PUFFER' or 'POGY' could move on to another submarine. In that case, welders and shipfitters could then have enough 'lead time' to do their work here in the yard on the present three submarines. But we didn't get a submarine contract in 1964, in 1965, in 1966, or in 1967."

The Navy later found that Litton had promised steel to its subcontractors prior to its own requested dates from the Navy and prior to the Navy's scheduled delivery dates.

On 11 September 1968, Litton sent the Navy a detailed schedule of steel delivery dates to support a 11-1/2 month delivery extension. This schedule requested delivery of hull steel starting 13 September 1968 and completing in March 1969.

The Navy attempted to accommodate Litton's September 1968 request as far as possible and was able to provide some hull steel at that time. However, Litton's requested dates for some items were far in advance of the Navy's own scheduled delivery dates and in advance of actual need. For example, Litton requested steel for reactor compartment canning plates almost a year earlier than these plates could have been used. Nevertheless, all of the

pacing items were either supplied by the Government or were otherwise available to Litton by March 1969, the end date specified by Litton in its contract proposal and in its September 1968 schedule.

The most important point is: Litton's records show that all steel work for the two pacing bulkheads on SSN 680 was completed within three and 21 days respectively of Litton's own schedules. Further, these records show that the delay in completing the pacing reactor compartment bulkheads was due to Litton-responsible items -- primarily the non-availability of contractor-furnished shielding material subsequent to the completion of steel work. Therefore, Litton's request for an additional six month extension in contract delivery dates, because of late Government-furnished material, is invalid.

While Litton stated that the reactor compartment bulkheads paced ship construction, it claimed that late delivery of subcontracted hull sections from Canadian Vickers contributed to the delay. Litton also attributed the delay at Canadian Vickers to late delivery of Government-furnished steel. The NAVSHIPS technical evaluation shows that this claim is not valid, either. Had Canadian Vickers met Litton's dates, as explained before, the ship would not have been completed any earlier -- because of Litton's problems in completing the reactor compartment. Again, while some Government-furnished steel was later than Litton's requested dates, Litton itself was responsible for up to six months delay in receipt of hull sections made by Canadian Vickers. Specifically:

a. Litton promised steel to Canadian Vickers before Litton itself was scheduled to receive it and earlier than Litton itself had requested it from the Navy. Many templates furnished by Litton were of improper dimension

and required rework, or were not made available and had to be lofted and manufactured by Canadian Vickers.

b. Many steel plates which Litton formed and supplied to Canadian Vickers were of improper dimension or configuration and required reforming. Other plates arrived damaged or heavily scratched and had to be repaired.

c. Litton supplied various fitting and frame jigs which had to be reworked because the plates were cut too short.

d. Most important, Litton took nearly ten months to resolve an ultrasonic testing problem at the subcontractor's plant. During this time, some completed hull sections waited up to four months to be tested, and then waited an additional two months to be shipped. Poor management attention by Ingalls to clear up these problems directly caused the six month delay in delivery of some hull sections to the shipyard.

Based on the above, the NAVSHIPS technical review team concludes that there is no basis whatsoever for Litton's claim for an extra six month extension due to late delivery of Government-furnished steel.

Loss of Learning

Litton claims 980,000 additional manhours for "loss of learning" due to the 17-1/2 month delivery delay. Litton claims that its original bid was based on the shipyard realizing learning curve labor efficiencies on the FY 1967/1968 submarine (SSN's 680, 682 and 683) as the 3rd, 4th and 5th ships of a 5 ship production run beginning with SSN's 648 and 652; that this transfer of learning would have been reinforced by work on SSN 647 (POGY) which the Navy transferred to Litton from another shipyard for completion of post-launching work; that practically all learning is lost when the time span

between like ships exceeds about 20 months; and that Government delays caused the ships to slip beyond this 20 month cutoff, thereby causing "loss of learning" equal to a 980,000 manhour decrease in labor efficiency.

The NAVSHIPS technical evaluation points out that Litton cannot document or identify what allowances, if any, it made for learning in its original bid. The number of hours claimed come from a "reconstruction" by Litton of its initial bid based on discussions with employees. Litton states that personnel involved in making estimates for the initial bid routinely use learning curve techniques. The presumption is that these personnel would have reduced the raw estimates for SSN's 680, 682 and 683 to take into account the learning effect from prior work on SSN's 648, 652 and 647. The team could find no evidence that this, in fact, was done.

Based on its own criteria, Litton should not have priced SSN's 680, 682 and 683 in anticipation of learning benefits from the contract for SSN's 648 and 652. Litton claims all learning is lost after a 20 month gap in production. The time span between the SSN 652 and the SSN 680 did not fall within this 20 month period. Start of construction for SSN 652, the last submarine Litton built from the keel up, preceded the projected start date of SSN 680 by over five years; launch of SSN 652 was 2-1/2 years before projected launch of SSN 680; delivery of SSN 652 preceded projected delivery of SSN 680 by 26 months. Extension in delivery of SSN's 680, 682 and 683, therefore, is not a valid reason for claiming "loss of learning" from SSN 652.

According to its own criteria, Litton should not have expected any significant labor reductions based on learning from work in completing POGY (SSN 647). POGY could not contribute to learning for pre-launch construction work on the SSN 680 since all work prior to launching POGY was performed at

another shipyard. Even at the time of contract signing, SSN 680 was not scheduled to be completed until 23 months after the scheduled completion of POGY -- well beyond the 20 month cutoff date Litton uses for learning efficiencies. From the above it appears highly unlikely that the Litton personnel involved in making estimates for SSN's 680, 682 and 683 would have applied learning curve reductions as claimed by Litton. To have done so would have been a violation of Litton's own criteria.

Moreover, POGY schedules subsequently slipped enough so that the interval between actual completion of POGY and the currently scheduled completion of SSN 680 is about the same as it was at the time of contract award. Thus the extension of the SSN 680, 682 and 683 delivery dates could not have deprived Litton of whatever learning benefits POGY offered in work after launch.

The review team concludes that Litton's claim for 980,000 manhours due to "loss of learning" is unfounded. Litton's higher than anticipated labor expenditures can more plausibly be attributed to the shipbuilder's inability to win a new submarine contract between March 1963 (FY 1963 program) and June 1968 (FY 1967/1968 program); to poor planning; to high labor and management turnover; and to poor management -- but not to extension of contract delivery dates on the SSN 680, 682 and 683 contract.

Function-of-Time Costs

Function-of-time costs are those housekeeping and service function costs directly related to the amount of time that the ships are in the keel-to-delivery phase of construction. Litton claims 30 ship-months as the total additional time the SSN's 680, 682 and 683 remained in this keel-to-delivery period. The entire 30 ship-months, according to Litton, are the Government's

responsibility. Estimating an average of 150 men per day, Litton claims a total of 751,000 manhours.

As explained previously in the discussion on late Government-furnished steel, all delays beyond the 11-1/2 month extension are considered to be Litton's responsibility. Moreover, Litton inflated the delay period by using 4 August 1969 as the SSN 680 keel-laying date. In another section of its claim, Litton points out that the 4 August keel laying was a ceremonial affair, and the actual keel-laying date was 24 November 1969. After adjusting for these factors, the NAVSHIPS technical review team concluded that Litton is entitled to only 10-1/4 months of the 30 months claimed. Moreover, Litton's manhour estimate was based on an estimate of the average manloading for time related functions on SSN 648 during the keel-to-launch period. A review of the total manhours for SSN 648 during this period revealed the manning to be 99 men instead of 150.

Taking all these factors into account, the NAVSHIPS technical review team concluded that Litton is entitled to only 171,000 manhours, instead of the 751,000 hours claimed.

Uncollectible Escalation

In its May 1972 proposal, Litton claims $4.6 million for "uncollectible escalation." Allegedly, this is the amount of labor escalation which Litton has incurred or expects to incur beyond that recoverable under the proposed escalation table.

NAVSHIPS owes Litton an adjustment in labor and material escalation for the 11-1/2 month delivery extention, but not for contractor-responsible delays

or overruns. According to escalation calculations by SHIPS 0511, the net adjustment to escalation tables for the 11-1/2 month extension would provide Litton about $2.5 million for additional labor and material escalation. Litton may be entitled to some additional escalation for labor-rate growth in excess of the Bureau of Labor Statistics index for the 11-1/2 month stretch-out period. The precise amount will have to be determined by NAVSHIPS 05 and 02.

Cost Overrun

The SSN 680, 682 and 683 contract is overrunning by roughly the amount of Litton's claim. The Litton claim, if honored in full, would turn a substantial loss into a substantial profit. In fact, Litton would obtain a higher profit than the initial target profit allowed in the contract. Although Litton attributes virtually the entire cost overrun to the Navy, it appears that most of the overrun was a result of the contractor's over-optimism in its initial bid and of gross mismanagement thereafter -- not of Government-responsible delays.

With the benefit of hindsight, and of data provided by Litton that NAVSHIPS did not have at time of contract award, it appears that, in pricing the basic contract, Litton assumed a substantial risk of potential cost overrun. In 1968, Litton had not received a new construction SSN contract since FY 1963. Litton officials expressed a keen desire to obtain some of the FY 1967/1968 submarines to keep the shipyard in the nuclear submarine construction business.

In fact, the President of Litton's Ingalls Nuclear Shipbuilding Division wrote to his employees on July 22, 1968:

> "Since I last wrote to you, we were awarded a contract to construct three new submarines. As you know, we had not received a new submarine contract award since 1963. It is only because of our performance in the last eighteen months which qualified us for this submarine construction award this year. The fact that we have these new submarines should give us great satisfaction, but should not be any cause for relaxing. We must concentrate on producing quality submarines on schedule if we are to continue to participate in the submarine program. It was a miracle that we were able to reinstate ourselves in the good graces of the Navy, and we could never expect a second miracle. We must show the Navy every day in the future that we are capable of maintaining the sustained good performance of the past year. (Emphasis added)
>
> * * *
>
> "All in all, and even despite some of the uncertainties because of Washington's budget problems, we have much to be thankful for this year."

Despite the long break in receiving a new submarine contract, Litton's bid was almost $5 million per ship lower than its more experienced competitors'. However, since Litton's bid was roughly in line with historical prices, NAVSHIPS did not challenge the bid as a "buy in." Moreover, NAVSHIPS made the Litton award based on competition and therefore did not have access to the cost or pricing data Litton used in preparing its bid.

Litton states that the basis of its bid is not documented in its files. Therefore, the company reconstructed a basis for its bid. In this reconstruction, Litton applied an 11 percent management improvement factor (reduction) to its historical cost experience in order to come up with its original bid price. The important point is that, at the bid price, Litton itself concedes it would have had to realize substantial management improvements to avoid a serious cost overrun.

In reviewing the situation in light of what we know today, and considering some of the problems facing Litton at the time of contract award, there is no question but that Litton's bid was extremely optimistic.

The team was unable to determine to what extent Litton actually realized the predicted savings from management improvement. However, it appears that not much improvement was made; in fact, the team found case after case of mismanagement. Specifically:

a. Litton worked to unrealistic pre-keel schedules. Instead of scheduling work to accommodate expected steel deliveries and the 11-1/2 month extension requested by the Navy, Litton accelerated its pre-keel work over the schedule it had proposed for the contract. Litton's schedules ignored information regarding projected deliveries of Government-furnished steel and ignored shortages of qualified workers in critical trades.

b. Litton did not maintain adequate management control and surveillance over subcontract work.

c. Litton experienced excessive rework because of poor control over work in its shops and on the waterfront. The Navy repeatedly complained to Litton management about the high rate of errors and rework, both of which led to high costs.

d. Litton did not have effective cost control over the contract work. Under Litton's systems, working level budgets are not related to contract amount. Thus, it is possible to meet all labor budgets at the working level and still substantially overrun the contract.

e. Litton did not have effective control over materials. On many occasions, Litton reported that items of Government-furnished equipment were

overdue at the yard. In every case but one, where NAVSHIPS investigated the problem, the missing items were located at the shipyard.

Litton's poor management was not confined to the SSN 680, 682 and 683 contract. Litton has also experienced substantial delays and cost overruns on its other ship construction contracts. Specifically:

a. Nearly every Navy shipbuilding contract (SSN 680, 682 and 683, AE 32-35, LHA) with Litton is behind schedule and overrunning in cost. Moreover, Litton has large claims pending against the Government on all of these contracts. The only exception to date is the DD963 class shipbuilding contract where work has barely started.

b. The General Accounting Office (GAO) recently reported that Litton's poor procurement practices were causing unnecessary additional costs. The GAO conclusions grew out of a specific review of subcontracts placed under the SSN 680, 682 and 683 contract.

c. The Maritime Administration has also reported extensive problems in Litton's construction of Farrell and American President Line ships.

In December 1970, Litton Corporation changed management of its Ingalls yard. Since then there has been some recovery of the delays experienced on the SSN 680, 682 and 683 contract, but the ships are still about four months late to the 11-1/2 month extension schedule. There have also been extensive management changes in Litton's West Bank yard.

Claim Backup Data

The NAVSHIPS technical review team found very little information in Litton's backup data to support its claim. Most of the claim consists of Litton assertions, judgments, and allegations for which the company can

not provide factual support. Although Litton vigorously denies that it "backed into" the claim, it is noted that:

a. The amount of the claim approximates Litton's projected cost overrun. If honored in full, the Litton claim would enable the company to recover its costs and still make over a $7 million profit on the contract.

b. Although Litton has revised its claim proposal five times, the total amount Litton seeks to recover has remained relatively constant.

c. Whenever the NAVSHIPS team has gathered facts tending to invalidate items of Litton's claim, Litton has dropped these items and substituted others in their place.

d. As explained previously, Litton used a so-called management improvement factor to explain the difference between its reconstructed estimates and the bid price. The bid price is substantially lower than reconstructed estimates, which are based on historical costs. Originally, Litton claimed this factor was 6 percent. Later, when it reduced the basis of the claim in another area, this factor was increased to 11 percent. This change from 6 percent to 11 percent permitted the total amount of the claim to remain about constant.

The NAVSHIPS team has spent many man-months in evaluating small portions of the claim. In many areas the team has found the claim misleading, inaccurate and inconsistent. For example, in the nuclear area alone:

a. Litton claimed several thousand additional manhours for extra plan changes because the ships were delayed by late Government-furnished material. Litton supported the claim with a calculation showing the average number of

plan changes over a portion of the ship construction period. This average was extended over the period of claimed delay. In this manner Litton claimed 37 plan changes per month when, in fact, the rate during the actual delay period was about four per month. In total, the team found this part of the claim overstated by a factor of 20.

b. To support a claim for additional engineering effort to make changes in technical manuals, Litton used the same rationale it used for plan changes. However, in this case the team found that 20 percent of the changes counted in the "average" were not even applicable to the ships Litton was building. Moreover, Litton maintains several copies of some manuals. In these cases Litton counted each copy of a technical manual change as if it were a separate item requiring engineering effort. In effect, Litton claimed several hours of engineering time for some changes that took only a few minutes of clerical effort. The team concluded that Litton overstated its costs in this part of the claim by a factor of six.

c. Litton claimed it had to use extra service personnel for the period Litton was delayed by the Navy. Litton claimed more than five times as much for some categories of these personnel as its records show was actually spent.

d. Litton claimed about 44,000 engineering manhours in its claim for Government-responsible delays in one area. However, the total Litton engineering effort in this area for a 38 month period that included the delay was only about 32,000 manhours. The Government analysts concluded this facet of the claim had no substance.

In April 1972, the Navy asked Litton management (Mr. Marandino, the President of Ingalls Nuclear Shipbuilding Division) to review and certify

its claim. As a result of this request, Litton deleted items totaling several million dollars. Some of the above items were dropped in this process. However, new items were substituted as an offset to the reductions.

3. Conclusions and Recommendations.

The NAVSHIPS technical evaluation indicates that Litton is entitled to only about 14 percent of its claimed manhours. Using the company's labor and overhead rates and considering all items for which the Navy might be responsible, the NAVSHIPS technical evaluation indicates that a settlement in the range of $4-7 million, including escalation adjustments, would fairly compensate Litton for its additional costs due to the Government-responsible contract extension. An analysis of this computation is attached. The contractor's claim for an additional six month delay for late Government-furnished steel and so-called "loss of learning" is not warranted. The range of $4-7 million compares favorably with the tentative settlement NAVSHIPS reached with Litton before it was disapproved by NAVMAT in December 1969.

Since December 1969, the Litton claim has grown by a factor of six. The NAVSHIPS team concludes that this growth was prompted by overruns that developed as work progressed, and that the cost growth does not, in any way, reflect a reasonable assessment of the Government's liability.

The Navy should resist any Litton efforts to settle the claim on a total cost basis. To do so would reward inefficiency and encourage future claims by Litton and other shipyards. Moreover, it would be a bad precedent for the Navy's negotiations with Litton on the LHA, AE, and possibly the DD 963

projects. For this reason, it is recommended that the Navy:

a. Reject Litton's current proposal.

b. Offer to settle with Litton in the $4-7 million range.

c. If Litton will not accept the offered settlement, issue a contracting officer decision denying the excessive portion of the claim. If Litton then decides to pursue the rejected portion of the claim, this should be as a contract dispute before the Armed Services Board of Contract Appeals, or, finally, in the courts.

d. Make no provisional payments or progress payments beyond those presently provided for in the contract until this matter is settled.

e. Do not consider Litton for any future naval ship construction awards until this matter is settled and until Litton and the Navy reach agreement on a new business relationship -- one that does not rest on overpriced changes and excessive claims.

SUMMARY OF NAVSHIPS
TECHNICAL ANALYSIS
OF LITTON CLAIM UNDER CONTRACT N00024-68-C-0342

	LITTON CLAIM	NAVSHIPS TECHNICAL EVALUATION (See Note 1)	
Manufacturing:			
Hours	1,297,000	171,000	
$	$26,446,000		$1,199,000
Regular Engineering			
Hours	61,000	24,200	
$	888,000		174,000
Nuclear Engineering:			
Hours	112,000	20,000	
$	1,471,000		156,000
Other:			
Hours	58,000	0	
$	565,000		0
Material:			
$	6,766,000		3,000
Subtotal	$36,136,000		$1,532,000
G&A	3,725,000		92,000
Unrecoverable Escalation	4,561,000		(See Note 2)
TOTAL COST:	$44,422,000		$1,624,000
Less Formula Escalation:	(16,931,000)		0
Net Target Cost	27,491,000		1,624,000
Target Profit	3,084,000		114,000
Target Price	30,575,000		1,738,000
Additional Escalation due to Extension:	6,431,000		2,460,000
TOTAL Claim:	$37,006,000		$4,198,000 (See Note 3)

ATTACHMENT 1 to ENCLOSURE (1)

Notes:

1. The NAVSHIPS technical evaluation does not reflect the DCAA audit of Litton's claimed labor and overhead rates. Therefore, to the extent that audit adjustments reduce Litton's claimed rates, this evaluation should be adjusted downward.

2. The company claims total escalation costs of $21.4 million. The revised escalation tables proposed by SHIPS 0511 would allow $13.0 million, an $8.4 million difference. Most of the $8.4 million appears due to contractor responsible delays, cost overruns or the contractor's re-definition of costs subject to escalation. PMS381 and SHIPS 08 review of the claim indicates no valid basis for uncollectible escalation.

3. Litton's letter of June 13, 1972 stated that as of that date, the Navy had received all data which Litton desires to furnish for use by the Navy in evaluating this claim. As noted in the Summary, the NAVSHIPS technical review team found very little information in the backup data to support Litton's claim. It is possible that at the time of negotiations, Litton may provide clarifying data which would cause some of the allowances in the technical analysis to be revised. Possible additional allowances are as follows:

a. Possible additional allowance for escalation over and above that allowed in the tables if Litton is able to substantiate actual escalation in excess of tables on basic allowed costs, exclusive of contractor responsible overruns and delays, and changes.

b. Possible additional allowance for "function of time" costs based on additional manning beyond SSN 648 actuals.

c. Possible additional allowance for negotiation of judgmental items in the technical evaluation beyond that allowed in the technical analysis.

d. Possible additional allowance for pre-keel delay and disruption due to steel not arriving in schedule sequence and Litton substitutions.

PMS381 and SHIPS 08 consider that the maximum possible additional allowance in the above areas would not exceed $3.0 million.

Summary of Litton Systems Incorporated Claims Against Navy Contract N00024-68-C-0342
for Delay in Construction of SSN 680, 682, and 683

Additional $ Claimed	November 1970	February 1971	December 1971	April 1972	May 1972
			($ in millions)		
Target Cost	$27.411	$29.835	$39.433	$41.868	$27.491
Target Profit	4.112	4.381	6.952	7.195	3.084
Target Price	$31.523	$34.216	$46.385	$49.063	$30.575
Plus or (minus) escalation estimated to be above or (below) that amount specified in the contract (see Note 1)	9.0	9.3	(6.27)	(6.27)	6.4
Total "Actual" Claim (to nearest .1 million)	$40.5	$ 43.5	$40.1	$42.8	$37.0

See attached pages 2-5 for explanation of changes in Litton claim

Note 1:Current Estimated Escalation in Contract = $10.544M

ENCLOSURE (2)

A. Changes in Litton's Proposals of November 1970 and February 1971

About $3 million increase in "actual" claim. Small increases in hours claimed more than offset by slightly lower overhead rates. Increases due to following:

		($ in millions)
1.	Contract with Chicago Bridge & Iron - about $1.8 million ("inadvertently omitted from the 20 November 1970 proposal.")	$1.8
2.	Claim for "retainage" - (New to February proposal) -	.63
3.	Higher G&A -	.3
4.	Higher Profit	.27
5.	Estimated additional escalation due to higher target price	.3
6.	Increased manhours offset by decreased overhead rates	-.3
		$3.0

B. Changes in Litton's Proposals of February 1971 and December 1971

About $3.4 million decrease in "actual claim". $12.17 million increase in target price more than offset by $15.57 million decrease in escalation tables.

Differences:

1. Decrease in claimed manhours of almost 22%.
2. Large increase in claimed dollars because labor and overhead rates are escalated.
3. Increase in G&A of $.6 million.
4. Increase in Profit of $2.6 million.

Decrease in manhours due to:

1.	Decrease in claimed "loss of learning" (due to dropping SSN 639 from learning curve) -	139,000 hrs
2.	Decrease in "function of time" (hours revert to same total as in November, 1970 proposal) -	125,000 hrs
3.	Changing "Reduced Productivity" to "Pre-keel Delay + Disruption -	98,000 hrs
4.	Dropped 44% of claimed Reg Engineering Hours	75,000 hrs
5.	Dropped 4% of claimed Nuc Engineering Hours	7,000 hrs

Note that the arguments for all of these areas changed, in some cases, substantially. The switching of "Decreased Productivity" to "Pre-keel Delay and Disruption" necessitated new and complete NAVSHIPS analysis.

C. Changes in Litton's Proposals of December 1971 and April 1972

About $2.7 million increase in "actual" claim, all due to an "accounting change" at Litton.

Effect of the Accounting change.

1. Increased manhours by 85,000 hrs. Most of the increase came in the new category "other direct labor" for which no backup was provided, but for which Litton stated backup existed at their company for the Navy to review.

2. Labor and overhead rates increased.

3. Material overhead decreased.

4. Increase in profit of $240,000.

D. Changes in Litton's Proposals of April 1972 and May 1972

About $6 million decrease in "actual" claim. Decrease in target price of $18.5 million offset by escalation increase of $12.5 million.

		($ in millions)
1.	Decrease in Regular Engineering hours of 31%	$ -.2
2.	Decrease in Nuclear Engineering hours of 39%	-.55
3.	Decrease in claimed material	-.55
4.	Decrease in G&A	-.1
5.	Increase - new category - essentially uncollectible escalation	+4.56
6.	Decreased Profit	-4.1
7.	No longer claimed "retainage"	- .63
8.	No longer claimed material escalation separately	-4.27
9.	Miscellaneous, rounding	- .16
		$ -6.0

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-554
19 JUL 1972

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Ingalls Nuclear Shipbuilding Division, Litton Systems, Incorporated, claim against the Navy under N00024-68-C-0342 for construction of SSNs 680, 682, and 683

Encl: (1) Summary of Navy Technical Evaluation of Litton Systems, Incorporated Claim,SSN 680, 682, and 683 Contract
(2) Defense Contract Audit Agency memo ser CAR-1.24 dtd 11 Jul 1972

1. On 17 July 1972, NAVSHIPS negotiated with Litton on the SSN 680, 682, and 683 claim. Litton made no concessions and rejected NAVSHIPS' offer. Litton's claim remains at $37 million.

2. Upon conclusion of negotiations, since no agreement could be reached, the Contracting Officer (Rear Admiral K. L. Woodfin) stated he would issue a formal decision which Litton, if it desired, could appeal to the Armed Services Board of Contract Appeals. Mr. Marandino, the president of Ingalls Nuclear Shipbuilding Division then stated that Litton would be trying to reach a settlement through "other channels" — presumably higher level Government officials. Since you undoubtedly will be one of the "higher level" officials to whom Litton will appeal, I recommend that you refer Litton back to NAVSHIPS for any discussion of the submarine claim.

3. Following are facts you and other senior Navy officials who may become involved should know:

a. The Litton claim is grossly inflated. NAVSHIPS has conducted detailed analyses of this claim, using data from Litton's own files. This data shows that only $4 - $7 million can be justified, not $37 million. Delays attributed to Government actions by Litton were, in fact, caused by its own poor planning, by its manpower shortages, by its late material purchases and deliveries and by mismanagement of the contract.

b. Enclosure (1) summarizes the NAVSHIPS technical analysis of the Litton claim. I recommend that you and other officials who may be contacted by Litton read it carefully so you will have a better understanding of what the claim involves.

c. During the negotiations, NAVSHIPS laid out its position, point by point, so that Litton could have the opportunity to correct any misunderstanding or errors in factual data, and Litton was invited to rebut the NAVSHIPS tentative position. Litton indicated general disagreement with the conclusions. Nevertheless, it was unable to reconcile its claim with the evidence presented by NAVSHIPS.

d. The amount of the claim approximates Litton's projected cost overrun on this contract. Nearly all of this overrun has been found by NAVSHIPS to be due to Litton's mismanagement of the contract and over-optimism in its bid. Litton did not appear to be at all concerned that its claim does not support a payment anywhere near the $37 million figure. The company's position seems to be that it spent the money so it is up to the Navy to cover all Litton costs and all the profit included in its bid — regardless of whether the overrun was Litton's or the Government's fault.

e. Mr. Marandino made no attempt to negotiate. Thus, NAVSHIPS' efforts in presenting the facts to Litton were a waste of time, except that the Litton response to the specific points raised by NAVSHIPS seemed to confirm that the NAVSHIPS' analysis is sound.

4. In attempting to attribute its cost overruns to the Navy, Litton has, in my judgment, overstepped the bounds of propriety. Analysis of the claim indicates misrepresentation, if not fraud. Many elements in the claim appear contrived and are irreconcilable with facts contained in the company's own files. Enclosure (2), among other things, discusses one example — a case where Litton claimed an extra $4.5 million figure as uncollectible escalation when, in actual fact, there was no basis whatsoever for the $4.5 million.

5. In view of the history of this Litton claim, I recommend that a formal board be convened to investigate this claim and to determine whether Litton's actions constitute a violation of the False Claims Act or of other federal statutes. As an alternative the Department of Justice could be asked to review it.

6. The Litton claim is a complex matter. NAVSHIPS has gone to great pains to get to the bottom of the case and determine the facts — a step too often not employed in past handling of NAVSHIPS claims. Based on the effort expended in this case, unusual for NAVSHIPS, the Navy is in a strong position to contest the claim before any tribunal and to limit payment to that amount actually owed Litton. For this reason the claim should be settled on its merits through the normal contracting officer decision and appeals board circuit, and not by extra-legal action.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations & Logistics)
Assistant Secretary of the Navy
(Financial Management)
Office of General Counsel
Commander, Naval Ship Systems Command

DEFENSE CONTRACT AUDIT AGENCY
ATLANTA REGION
LITTON SHIP SYSTEMS DIVISION RESIDENT OFFICE
C/O SUPERVISOR OF SHIPBUILDING
PASCAGOULA, MISSISSIPPI 39567

REPLY REFER TO

CAR-1.24 July 11, 1972

MEMORANDUM FOR COMMANDER, NAVAL SHIP SYSTEMS COMMAND,
WASHINGTON, D. C. 20360

ATTENTION: Mr. Richard D. Everett

SUBJECT: Audit Review and Analysis of Escalation on the 680's Claim, Ingalls Nuclear Shipbuilding Division, Pascagoula, Mississippi

In accordance with your request, this office has reviewed the contractor's proposed method of including escalation in its latest revised claim for the 680 submarine contract.

The contractor's latest claim submission is presented on a basis which allows for the over or under recovery of escalation for the total contract. The proposed method is unacceptable to DCAA because it represents a method which allows for a total repricing of the contract. We recommend that the claim be priced separately from the basic contract and change orders. The incorporation of any pricing method or a total contract repricing method will allow for recovery of losses on the basic contract and can not be recommended.

There are two other methods of pricing escalation on the subject claim which we have explored. One method would be to price the claim on a de-escalated basis and revise the escalation contract formula for payment of escalation applicable to the claim. The other method would be to price the claim on an escalated basis. The method of pricing the claim on a de-escalated basis on an after-the-fact basis is not acceptable because of the problems inherent in determining the de-escalated base labor and overhead rates as well as base estimates for materials. It is almost impossible, especially in overhead rates, to split incurred costs into the categories of escalation costs and base incurred costs. Based on our detailed review and analysis we recommend that the claim be priced on an escalated basis and that the basic portion of the contract remain on a de-escalated basis as originally priced in the contract. This recommended method is in consonance with the change order pricing formula on the contract.

In the claim it is our understanding that legal entitlement for an additional four quarters has been determined for escalation contract formula purposes. This office has reviewed in detail the revised material and labor spread which has been included in the tentative developed revised

CAR-1.24 July 11, 1972

SUBJECT: Audit Review and Analysis of Escalation on the 680's Claim, Ingalls Nuclear Shipbuilding Division, Pascagoula, Mississippi

In the contractor's latest revised proposal it included a computed figure of twenty-one million dollars for actual escalation. Also, adjustment of approximately four and one-half million dollars for the over recovery of escalation assuming that escalation recovery would be made on a total contract basis. We have had numerous meetings with the contractor in an attempt to obtain supporting documentation and rationalization of these figures. The contractor did not make a computation of actual escalation on the contract and could not support the twenty-one million dollar figure. In addition, they were never able to support the four and one-half million dollar adjustment figure that was included in the proposal. Our analysis based on the information obtained, indicated that this four and one-half million dollar figure represented a figure computed using total estimated contract incurred cost less monies received or expected to be received in claims.

In summary, based on our total analysis we recommend that the contract escalation formula (Article 16 of the contract) be applicable only to the basic price of the contract and that the claim be priced on an escalated basis. The escalated amount recovered through the formula will reasonably pay the contractor for its actual escalation on the contract. However, in settlement with the contractor, the agreement documentation should be prepared in a manner which will assure that the contractor understands that this represents the total and final amount payable for escalation applicable to the basic contract.

FOR THE REGIONAL MANAGER

Urray G. Ballard

URRAY G. BALLARD
Resident Auditor

CAR-1.24 July 11, 1972

SUBJECT: Audit Review and Analysis of Escalation on the 688's Claim, Ingalls Nuclear Shipbuilding Division, Pascagoula, Mississippi

formula by NAVSHIPS. Our review was made to determine if the distribution of the material and labor cost was reasonable when compared to the actual distribution based on incurred cost. In addition, our review was made to determine the amount of escalation recovery that would be estimated to be paid through the revised tables for escalation versus the amount of computed actual escalation for the basic contract. This computation is shown below for your information.

Direct Costs	Labor			Subtotal Labor (000)	Material (000)	Total (000)
	Mfg. (000)	Reg. Engr. (000)	Nuc. Engr. (000)			
Estimated cost escalated - Basic contract	$40,356	$1,503	$1,482	$43,341	$45,518	$88,859
Estimated de-escalated cost	33,565	1,192	1,079	35,836	41,058	76,894
	$ 6,791	$ 311	$ 403	$ 7,505	$ 4,460	$11,965
Indirect labor				1,576		1,576
Computed actual escalation	$ 6,791	$ 311	$ 403	$ 9,081	$ 4,460	$13,541
Escalation recovery computed using revised formula tables						$12,765

As shown above, our computation of actual escalation on the contract approximates the amount of escalation that will be recovered under the revised contract formula. It is understood that these figures and estimates are accurate within a range of 95 to 100%. We also made a computation of the escalation that would be recoverable under the formula if the distribution of material and labor were based on the actual distribution of incurred costs. That figure amounted to approximately seventeen million dollars. The distribution of labor and material as included in the revised contract formula by NAVSHIPS is considered to be very accurate and reasonable in relationship to the actual amount of computed escalation applicable to the basic contract.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-555
21 JUL 1972

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, claims against the Navy on contracts for construction of SSNs 680, 682, and 683 and AEs 32 through 35

1. As you know, NAVSHIPS was unable to reach agreement with Litton on either the SSN 680, 682, and 683 claim or on the AE 32-35 claim during negotiations on 17-19 July 1972. The two claims total about $75 million, but NAVSHIPS considers it owes Litton about $7 million. In view of this wide difference and since no agreements were reached, Litton was notified that a formal contracting officer's decision based on the NAVSHIPS position will be issued promptly. Litton, if it so desires, may then appeal to the Armed Services Board of Contract Appeals to settle the dispute.

2. These developments, in conjunction with the other problems the Navy has been experiencing with Litton, may have considerable impact on the company. One criticism leveled against the Department of Defense in connection with the Lockheed C5A case was that the Department of Defense did not make known the full extent of its difficulties and actions with the contractor. More recently, there have been press reports of a Congressional inquiry to the Securities and Exchange Commission regarding Litton's failure to disclose in its financial statements the extent of its claims against the Navy and regarding the extent Litton may be reporting earnings predicated on optimistic projections of claim settlements. To avoid such criticism of the Navy I therefore recommend the following:

a. NAVSHIPS should advise the Securities and Exchange Commission of the results of its recent negotiations with Litton and of the fact that it is preparing to issue a contracting officer's decision on these claims. This notification should indicate the amount of the contractor's claim and the approximate amount of the contracting officer's decision.

b. The Navy should make a public announcement of the fact that it has failed to reach agreement with Litton on these claims and that it is preparing to issue a contracting officer's decision which Litton may, if it desires, appeal to the Armed Services Board of Contract Appeals.

I believe such actions would do much to restore public credibility and confidence in the Navy's handling of its large shipbuilder claims.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations & Logistics)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-558

9 AUG 1972

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Recommendations for improving Navy claims procedures based on experience gained from Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, claim against the Navy under Contract N00024-68-C-0342 for construction of SSN's 680, 682, and 683

Ref: (a) My memorandum dtd 19 Jul 1972 for the Chief of Naval Material; subj: Ingalls Nuclear Shipbuilding Division, Litton Systems, Inc., claim against the Navy under N00024-68-C-0342 for construction of SSN's 680, 682, and 683 with encl (1) thereto

Encl: (1) My memorandum dtd 10 May 1971 for the General Counsel of the Navy; subj: Shipbuilder claims
(2) My memorandum dtd 11 Feb 1972 for the Chief of Naval Material; subj: Claims procedures

1. As you are aware, I have been concerned about the Navy's claims processing procedures for some time. In enclosures (1) and (2), I made recommendations for handling major claims against the Government. The purpose of this memorandum is to amplify these recommendations based on my experience with the subject Litton claim.

2. By reference (a) I advised you of the facts surrounding Litton's claim, and of the difficulties the Navy has encountered during the past year and a half in trying to evaluate it. Since December 1969 Litton submitted five different versions of this claim. The claim itself consisted of many smaller claims, each of which NAVSHIPS had to research and evaluate. Often after NAVSHIPS obtained facts which tended to disprove a particular item in the claim, Litton would withdraw that item and substitute another in its place. NAVSHIPS then had to conduct another evaluation. This repetitive submission and evaluation of Litton claim proposals has added substantially to the time required for the NAVSHIPS evaluation.

3. The data Litton provided to support its claim was incomplete and often unreliable. The company omitted data that did not support its claim. It was up to NAVSHIPS to collect relevant information and to piece together a balanced view of the facts. In this regard, NAVSHIPS had to rely mostly on contractor files because NAVSHIPS itself does not have a systematic method of collecting and recording significant data concerning contract performance.

4. After many man years of effort by NAVSHIPS technical, project, contract, and legal personnel, NAVSHIPS was able to reconstruct, with reasonable accuracy, what actually happened. The NAVSHIPS evaluation showed that the Government was liable for only about $4 - $7 million of the $37 million claimed by Litton. Litton had experienced a large cost overrun on the contract and, through its claims, was trying to pass the entire overrun to the Government.

5. The Litton claim read convincingly. But after NAVSHIPS had carefully reconstructed the facts it became obvious that the claim was greatly exaggerated. For example:

a. Litton claimed that late Government-furnished steel disrupted hull construction and eventually delayed ship deliveries by six months. In fact, steel work on the pacing items was completed essentially in accordance with Litton's schedules. Moreover, Litton's own weekly production reports showed that construction was proceeding smoothly.

b. Litton claimed that submarine hull sections had to be subcontracted due to late Government-furnished steel. Yet Litton's own documents prepared at the time the hull sections were subcontracted stated that the reason for subcontracting was a shortage of skilled manpower at the shipyard.

c. In its fifth claim submittal, Litton introduced a new $4.6 million item entitled "Escalation in Excess of Total Estimated Escalation Payments to be Made Under Article 16 (proposed)". This item turned out to be simply a "plug figure" to keep the claim at about $37 million, after Litton had to drop other claim items that had been discredited during the NAVSHIPS evaluation. The Government auditor found there was no support for the item.

6. Litton was unwilling to negotiate the claim on an item-by-item basis. During the negotiation sessions, NAVSHIPS presented its evaluation of the claim and invited Litton to point out any errors in the NAVSHIPS analysis. Litton disagreed in general with the NAVSHIPS conclusions but provided no evidence to refute them. The company's approach seemed to be that it had spent the money claimed and it was up to the Navy to reimburse Litton, whether or not the company could demonstrate legal entitlement to the money. The company said that if NAVSHIPS would not agree to virtually the full $37 million claim, Litton would pursue settlement through other channels — presumably with higher level Navy officials.

7. Faced with Litton's continuing intransigence, NAVSHIPS was forced to issue a formal contracting officer's decision; Litton may appeal this decision,if it so chooses, to the Armed Services Board of Contract Appeals. If Litton does appeal, NAVSHIPS will have to spend many more man years of effort defending itself against this one $37 million claim. Considering that the Navy's current claim backlog is about $1.2 billion, we must streamline our claim processing procedures or most of NAVSHIPS' manpower will be consumed in claims work.

8. Our experience with the Litton claim shows that a contractor today holds the upper hand in the claims process. He has it in his power to make it impossible for the Navy to evaluate the claim. By changing items in the claim after the Navy has evaluated them, he can make the Navy spend months or even years in the evaluation process. He can make it difficult for the Navy to determine the facts. He can exaggerate his claims with impunity and with no penalty. Capitalizing on the resulting delays, he can exert political pressure to arrive at a favorable lump-sum settlement at higher management levels in the Navy, where the details of the claim are not known or understood. The Navy is then constantly placed on the defensive.

9. In order to improve its handling of shipbuilder claims, NAVSHIPS has gone into great detail to determine the contractor's specific legal entitlement and cost of each element of a claim. By following this procedure on Litton's SSN and AE claims, NAVSHIPS determined that only a small fraction of each claim was valid. However, NAVSHIPS cannot continue to apply so much effort on shipbuilding claims and still carry out its primary functions. The rules must be tightened so that the Navy can have ready access to relevant facts, so as not to be compelled to waste large amounts of time trying to evaluate claims that are not properly documented by the shipbuilder. Such access would produce a more prompt and equitable resolution of claims.

10. My specific recommendations are:

a. The Navy should reject promptly claims that are not adequately supported and documented. Contractors should be required to relate specific dollar amounts with individual items of a claim so that each item can be evaluated and settled on its merits. Contractors who repetitively submit unfounded or unwarranted claims, or those who frustrate the claims process by changing the basis of the claim during evaluation, should not be considered for future business when other viable sources are available.

b. The senior company official in charge at the plant or location involved should be required to certify, upon first submittal of a claim, that he has personally reviewed the claim and all supporting data, and that the information contained therein is current, complete, and accurate. Moreover, he should also certify that all information bearing on the claim, whether or not it is favorable to the company's position, has been disclosed. The Navy should prosecute the offenders in any case where a certification is erroneous.

c. The contractor should be required to differentiate between factual and judgmental data in his claim. Factual statements should be keyed to the specific supporting documents to facilitate evaluation.

d. Field contract administration offices should be required to maintain a daily record of significant events occuring during the life of each contract. The record should be supplemented by photographs, references to key documents, or other information as necessary to ensure a complete and independent record of contractor performance in the event of subsequent claims.

11. By requiring full and accurate disclosure of relevant facts the Navy would be better able to dispose of contractor claims promptly and equitably. Where agreements cannot be reached despite full disclosure of the facts, the Navy should make its determination and then let the matter be handled within the legal mechanism that was specifically designed and set up to deal with such disputes.

12. With regard to shipbuilder claims, we have become thoroughly trapped in a system of our own creation in which a contract entered into by the Navy is no longer a "meeting of the minds" but has become a license for the contractor to use every means he can devise to achieve his predetermined profit goals -- regardless of his actual performance. Our contractors have fully developed the concept that they are no longer bound by the contracts they freely entered into. And, in fact, they are not so bound since they are able to deal on an informal basis with high officials who are not familiar with the facts nor legally responsible for the contract. I submit that under these conditions there is no real contract in the traditional, legal, or moral sense of the term.

13. It is wrong to imagine that the system is better than its officials and that things will work out for the better no matter how our officials conduct themselves. I recommend that we go back to dealing with our contractors in the traditional legal and moral manner. We should require our contractors to deal with those who have been assigned responsibility for our contracts. We should establish rigid rules in accordance with the recommendations listed above for processing contractor claims. The machinery for this manner of dealing is legal and is available; it does not need or require informal interpretation on the part of those who are not themselves responsible for the contract.

14. I would appreciate being informed of what action you take with regard to my recommendations.

H. G. Rickover

Copy to:
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
OCT 5 1972

MEMORANDUM FOR THE DIRECTOR, NUCLEAR POWER DIRECTORATE,
NAVAL SHIP SYSTEMS COMMAND

Subj: Recommendations for improving Navy claims procedures based on experience gained from Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, claim against the Navy under Contract N00024-68-C-0342 for construction of SSN's 680, 682 and 683

Ref: (a) Your Memorandum 08H-358 of 9 Aug 1972, same subject

Encl: (1) NAVMATNOTE 4200 of 11 Aug 1972

1. This is in reply to reference (a) which forwarded recommendations for improving Navy claims procedures.

2. I concur with the thrust of the recommendations in reference (a). It is essential that the Navy's credibility be maintained throughout the claims settlement process. It must be made clear to all contractors that the claims route is not a means of by-passing, avoiding or mitigating the commitments made when contracts are undertaken as a result of the competitive procurement process or otherwise.

3. Paragraph 10 of reference (a) specifically outlines certain recommendations for improving Navy claims procedures. These recommendations are addressed in the same order for convenient reference:

a. Enclosure (1) is believed to be responsive to the first part of your paragraph 10.a. to the effect that the Navy should reject claims that are not adequately supported and documented. The further recommendation in paragraph 10.a. that contractors should not be considered for future business, who have repetitively submitted unfounded or unwarranted claims or who have frustrated the claims process, has been reviewed with the Office of General Counsel. It is the joint view of Hart Mankin and myself that such cases should be reviewed in each instance to ascertain whether any existing statutes have been violated. This should be coupled with vigorous action including suspension, debarment, or referral to the Department of Justice where any such violations are determined to exist.

b. Your recommendation in paragraph 10.b. may be utilized in some cases where there is reason to believe senior management levels of the

Subj: Recommendations for improving Navy claims procedures based on experience gained from Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, claim against the Navy under Contract N00024-68-C-0342 for construction of SSN's 680, 682 and 683

contractor may not be familiar with a particular claim. The thrust of your recommendation is already provided in certain statutory remedies, including the False Claims Act and the "Truth-in-Negotiations" statute, which contains penalties for improper certifications with respect to cost and pricing data. I concur that the Navy should prosecute offenders in any case where certifications are erroneous. It is essential that we get the required certifications and conduct negotiations at a level which can commit the contractor. On the other hand, I am in full agreement that we should require our contractors to do business with those who have been assigned responsibility for our contracts.

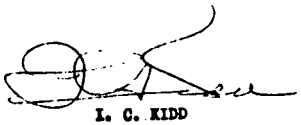
c. With respect to your paragraph 10.c., the recommendation suggesting that contractors be required to differentiate between factual and judgment data, and to identify or key factual statements to supporting documents is closely allied to the requirements in enclosure (1) for the claimant to demonstrate a causal connection between Navy acts or omissions and resulting claimed amounts by the contractor. Our discussions with OGC indicate that presently we do not have ASPR or NPD guidance specifying formats for claims presentations; however, if a contractor is held strictly to the causal approach, he must specify facts and the accompanying logical inferences relating causes with resulting claimed amounts. I have requested the Navy Chairman of the ASPR Subcommittee on the "Changes" clause to review this recommendation and to propose for ASPR consideration any format requirements deemed essential or desirable for contractor claims presentations.

d. I concur with the recommendation in paragraph 10.d. that field contract administration offices be required to maintain a record of significant events occurring during the life of each contract. The availability of "parallel documentation" types of information will be useful to clarify past events which tie into, or are being represented by contractors as, the basis of claims against the Navy. This will be directed by NPD and other means.

4. We must maintain the discipline in contract management and contract administration to settle issues with contractors currently as they arise, and avoid escalation into major claims. The tendency to postpone settlement of open issues for many months or even years must be resisted, and is, I consider, unsound management. We must be alert to adopt any further policy or procedural changes as will contribute toward current resolution of open issues and discourage their

Subj: Recommendations for improving Navy claims procedures based on experience gained from Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, claim against the Navy under Contract N00024-68-C-0342 for construction of SSN's 680, 682 and 683

postponement. I am dedicated to resolving the Navy's claims problem, and will take vigorous action against those contractors who submit spurious and unfounded claims.



I. C. KIDD

Copy to:
COMNAVSHIPSYSCOM
OGC (Mr. H. Mankin)
ASN (I&L)

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

Canc frp: June 73
IN REPLY REFER TO
NAVMATNOTE 4200
MAT 02B:JCC/OGC:DWJ
11 AUG 1972

NAVMAT NOTICE 4200

From: Chief of Naval Material

Subj: Policy Regarding Total Cost and Total Time Based Claims

1. Purpose. To promulgate a policy directive regarding "Total Cost" and "Total Time" based contractor claims.

2. Background

a. Contractors have occasionally submitted claims based on "total cost" or "total time" approaches, i.e., they have asserted that the government was wholly responsible for all costs incurred in excess of the contract price, or for all delay, without proof that such excess costs or delays were caused by government conduct--not by contractor conduct or by concurrent causes. Yet in changes claims there is a well-established requirement to demonstrate causality between the change and resulting quantum. This derives from the terms of the changes clause itself: "...if any such change causes an increase or decrease in the cost of, or the time...for...performance of any part of the work...." The total cost approach is suspect because it assumes that the contractor's initial contract price was reasonable; that the government alone caused his increased costs; and that the contractor's performance costs were reasonable. Only in few rare cases has the total cost approach been accepted as a "last resort"--when the contracting officer failed or refused to make the sort of equitable adjustment required by the changes clause and the circumstances allowed the contracting officer, board, or court to accept the three foregoing assumptions.

b. Thus a claimant filing a total cost based claim has the burden of establishing that there is no other feasible, acceptable basis for computing his increased costs. He must prove that there is no way of correlating government actions and omissions to historical cost elements or even to reasonably substantiated cost estimates. If the contractor fails to sustain this burden, then the Navy ought to reject his total cost claim.

3. Policy

a. As a policy matter the Navy should reject any contractor claim premised on a "total cost" or "total time" approach that does not meet the foregoing requirements. The general criteria for information

NAVMATNOTE 4200
11 Aug 1972

required to support settlement include the existence of a legal basis for entitlement, facts meeting the elements of proof required to support the basis of entitlement, and adequate factual support for the amounts claimed.

b. The Navy should require a proper claim submission on the basis provided in the changes clause, namely, a basis factually demonstrating documented scopes of work correlated to provable instances or categories of government liability. The Navy should, in all cases, require causal support and documentation of quantum, in as much specificity as the facts will permit.

4. Action. Addressees are requested to:

a. Give wide dissemination to the policies herein.

b. Apply these policies both with respect to new claims received as well as to claims which are now in the process of review.

5. Cancellation. Upon incorporation in the Procurement Directives and for record purposes 30 June 1973.

R. G. [illegible]man, III
Deputy Chief of Naval Material
(Procurement and Production)

DISTRIBUTION:
SNDL: FK
NAVSUP Special list X14 (all field purchasing offices and activities)

Copy to:
A1 (ASN (I&L) only)
A2A (OGC, ONR only)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08R-562

11 DEC 1972

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Recommendations for improving Navy claims procedures based on experience gained from Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, claim against the Navy under contract N00024-68-C-0342 for construction of SSN's 680, 682, and 683

Ref: (a) My memorandum dtd 11 Feb 1972 for the Chief of Naval Material, subj: Claims Procedures
(b) My memorandum dtd 9 Aug 72 for the Chief of Naval Material, same subject
(c) My memorandum dtd 19 July 1972 for the Chief of Naval Material, subj: Ingalls Nuclear Shipbuilding Division, Litton Systems, Inc., claim against the Navy under N00024-68-C-0342 for construction of SSN's 680, 682, and 683 with encl (1) thereto
(d) Your memorandum of October 5, 1972, same subject

Encl: (1) Actions to be taken by the Supervisor of Shipbuilding, Pascagoula regarding Claims and Claim Prevention

1. In references (a) and (b) I made recommendations for handling major claims against the government. In reference (c) I amplified those recommendations based on my experience with the subject Litton submarine claim. Reference (d) was your response to reference (c).

2. Reference (d) stated general agreement with the thrust of my recommendations and then commented on each of them. However, there are several points that I believe can and should be clarified with regard to reference (d). These are identified below:

a. I recommended that the Navy reject promptly claims that are not adequately supported and documented. Reference (d) enclosed a CNM policy statement which establishes criteria for rejecting claims submitted on a "total cost" or "total time" approach. However, some major claims inadequately supported by the contractor, do not fall into the "total cost" or "total time" category. Therefore, I recommend that your policy statement be expanded to require rejection of all claims that are not adequately supported and documented.

b. I recommended that contractors who repeatedly submit unfounded claims not be considered for future business. Reference (d) states that when it is determined that existing statutes or regulations have been violated vigorous action should be taken. I believe it is a mistake for the Navy to continue to do business with contractors who submit unfounded

claims even if such action does not violate existing statutes or regulations. I recommend that, as a minimum, a contractor's past poor record in the claims area be treated as a negative factor in evaluating that company's proposals for future business.

c. I recommended that the senior company official in charge of the plant or location involved be required to identify, upon submittal of the claim that he has personally reviewed the claim and all supporting data and that the information contained therein is current, complete and accurate. Further, I recommended that he also certify that all information in the company's custody or control, bearing on the claim, whether or not it is favorable to the company's position, has been disclosed. Reference (d) states that the thrust of my recommendation is already provided in certain statutory remedies including the Truth-in-Negotiations Act. However, it is my view that the Navy's procedures need to be strengthened to make the most out of current statutory remedies and to discourage the submittal of inflated and exaggerated claims. The Navy does not currently require that cost and pricing data be certified by top management and does not require certification until after negotiations are complete. When an item in the claim is challenged by Navy negotiators, the contractor frequently substitutes another in its place. Some contractors seem to set predetermined dollar targets for their subordinates and this encourages exaggeration and inflation in claims.

It would help curtail this practice if the Navy would require the senior company official in charge of the plant or location involved to certify personally the validity of the claim and the accuracy and completeness of the supporting data so that he, rather than his subordinates, would bear the penalty of false statements. Also, as I previously recommended, the certification should be submitted at time of claim submission, rather than after final agreement has been reached. In this way government personnel would not have to waste their time evaluating information which has not been thoroughly checked and certified by senior contractor management. Moreover, the contractor should certify that all information relating to the claim, not just data favorable to his position, has been disclosed. I think you would find fewer cases of inflated or unsupported claims if my recommendations in this area were adopted.

d. I recommended that contractors be required to differentiate between factual and judgmental data in their claims and that factual statements should be keyed to specific supporting documents. Reference (d) agrees with this recommendation and stated that the matter would be referred to the ASPR Committee. My experience has been that the ASPR Committee infrequently acts with dispatch. I recommend that you implement this requirement for Navy contracts while the ASPR Committee is deliberating.

e. I recommended that field contract administration offices be required to maintain a daily record of significant events occurring during the life of each contract. The record should be supplemented by photographs, references to key documents and personnel, and other information necessary to insure a complete and independent record of contractor performance in the event of subsequent claims. Reference (d) agrees with this recommendation and states that this will be directed by a Navy Procurement Directive and other means. At this time I do not believe that any formal instructions have been issued or that any action has been implemented at the field level, although I believe there has been general agreement among Navy officials on this matter for several years. In the absence of such directives, I met recently with the Supervisor of Shipbuilding, Pascagoula, and in one morning we worked out an agreement on the procedures he should follow to better protect the government against claims by Litton. Enclosure (1) is a copy of this agreement. NAVSHIPS procurement and contract administration officials approved these arrangements that same day. The need to start documenting contract performance is important and urgent. I recommend that we accelerate our efforts to establish overall guidance in this area throughout the Navy.

f. In summary, I recommend that the Navy:

a. Promptly reject inadequately supported or documented claims. The policy enunciated in enclosure (1) to reference (d) should be made applicable to all claims, and not limited to claims submitted on a "total cost" or "total time" basis.

b. Treat as a negative factor in evaluating a company's proposal for future business, a record of repeatedly submitting large, unfounded claims or a course of conduct designed to frustrate the settlement of claims.

c. Require the senior company official in charge of the plant or location to certify at the time of claim submission that (1) he has personally reviewed the claim and all the supporting data, (2) the data is current, complete and accurate, and (3) all information bearing on the claim within the company's custody or control has been disclosed, whether or not it is favorable to the company's position.

d. Implement within the Navy, pending ASPR action, the decision to require contractors to differentiate between factual data and judgment in their claims and to key facts to specific supporting documents.

e. Immediately implement the decision to require field contract administration offices to maintain a daily record of significant events occurring during the life of the contract; this should be supplemented by photographs, references to key documents and personnel, and other appertaining information.

08H-382

4. I expect that in the future we will see more, not less, claims activity. Our procedures for handling these claims should, therefore, be strengthened without delay to help put the Navy in the best possible position to defend itself against unwarranted and unfounded claims and to discourage submittal of such claims.

5. I would appreciate being informed of what action you take with regard to my recommendations.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations & Logistics)
Commander, Naval Ship Systems Command
Office of General Counsel

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
08H-2017

22 MAR 1973

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Recommendations for Improving Navy Claims Procedures

Ref: (a) My memorandum dtd 9 Aug 72 for the Chief of Naval Material, subj: Recommendations for improving Navy claims procedures based on experience gained from Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, claim against the Navy under contract N00024-68-C-0342 for construction of SSN's 680, 682, and 683
(b) My memorandum dtd 11 Dec 72 for the Chief of Naval Material, same subject
(c) Your memorandum of Oct 5, 72, same subject
(d) Your memorandum dtd Jan 19, 73, subj: Recommendations for Improving Navy Claims Procedures
(e) My memorandum dtd 19 Jul 72 for the Chief of Naval Material, subj: Ingalls Nuclear Shipbuilding Division, Litton Systems, Inc., claim against the Navy under N00024-68-C-0342 for construction of SSN's 680, 682, and 683 with encl (1) thereto

1. In references (a) and (b) I recommended specific actions to improve Navy claims procedures. In reference (c), you concurred in the thrust of those recommendations and, by reference (d), you forwarded enclosures implementing them. Since you and the Assistant Secretary of the Navy (Installations and Logistics) have expressed approval of these recommendations, I am concerned because the implementation of one of them is so wide of the mark as to constitute no improvement at all.

2. This recommendation as originally presented in reference (a), reads:

"The senior company official in charge at the plant or location involved should be required to certify, upon first submittal of a claim, that he has personally reviewed the claim and all supporting data, and that the information contained therein is current, complete and accurate. Moreover, he should also certify that all information bearing on the claim, whether or not it is favorable to the company's position, has been disclosed. The Navy should prosecute the offenders in any case where a certification is erroneous."

3. The Navy's implementation of this recommendation reads:

"c. The Navy should require, at the time of initial submission of a claim, that a responsible senior official authorized to commit the company submit an affidavit representing, to the best of his knowledge and belief, that --

i. company employees and officials have thoroughly investigated the facts surrounding the claim, and

ii. the conclusions drawn from discovered facts reasonably and accurately reflect the material damages or contract adjustments for which the Navy is allegedly liable."

This procedure will have little or no effect in stopping the difficulties being encountered. Worse yet, it palliates serious problems rather than cures them.

4. The above procedure is deficient in the following ways:

a. The senior management official should sign the certificate rather than one of his subordinates.

b. The certificate should assure that all data bearing on the claim, whether or not favorable to the company's position, has been disclosed and that the data is accurate, complete and current. The affidavit requires none of this.

In short, the implementation does not elicit the right assurances from the right man. Even if the affidavit, as written, were demonstrably false and even fraudulent, it is hard to see how it could be the basis of a lawsuit; if there is no creditable threat of court action, how does such an affidavit provide any incentive for the senior corporate official to ensure that data presented is accurate, complete and current?

5. My reasons for recommending that the Navy obtain a proper certificate on claim submittals were given in reference (b):

"The Navy does not currently require that cost and pricing data be certified by top management and does not require certification until after negotiations are complete. When an item in the claim is challenged by Navy negotiators, the contractor frequently substitutes another in its place. Some contractors seem to set predetermined dollar targets for their subordinates and this encourages exaggeration and inflation in claims. It would help curtail this practice if the Navy would require the senior company official in charge of the plant or location involved to certify personally the validity of the claim and the accuracy and completeness of the supporting data so that he, rather than his subordinates, would bear the penalty of false statements. Also, as I previously recommended, the certification should be submitted at time of claim submission, rather than after final agreement has been reached. In this way government personnel would not have to waste their time evaluating information which has not been thoroughly checked and certified by senior contractor management. Moreover, the contractor should certify that all information relating to the claim, not just data favorable to his position, has been disclosed. I think you would find fewer cases of inflated or unsupported claims if my recommendations in this area were adopted."

6. I consider that obtaining a proper certification of contractor claim submittals would be an important step in getting accurate, complete and current information in a timely fashion so that claims may be processed in a logical and efficient manner. It is extremely wasteful for Government personnel to review submission after submission while the contractor changes the facts, slanting some, failing to disclose others, and only signing the Truth-in-Negotiations certificate after the claim has been negotiated to settlement--sometimes after years of submissions and re-submissions. The Litton claim against the Navy for construction of SSN's 680, 682 and 683, which I summarized in reference (e), is a good example of such a case. The Government needs the assurance that accurate, complete and current data has been submitted by the contractor when the Government's team begins work on a claim, as well as at the conclusion of negotiations.

7. I recognize that ASPR policy is to obtain only one certificate under P.L. 87-653--at the end of negotiations. It was not always this way, and I recommend that in major claims (those in excess of $1 million) we require an appropriate certificate as recommended above with the initial submission and at the conclusion of negotiations.

8. I recommend that paragraph 4.c of NAVMAT NOTICE 4200 be rewritten and that ASPR 3-807.4 be changed as appropriate.

9. I would appreciate being informed of what action you take with regard to my recommendations.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Commander, Naval Ship Systems Command
Office of the General Counsel

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-2042

14 JUN 1973

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Obtaining outside assistance in defending against shipbuilder claims

1. On March 26, 1973, senior officials from the Naval Material Command, the Office of General Counsel, and the Naval Ship Systems Command, met with you to discuss how the Navy could better deal with its large backlog of contractor claims. You expressed concern at the large Navy backlog of shipbuilding claims, the likelihood of having to cancel ships if the Navy cannot successfully defend itself against these claims, and the substantial time and effort of key Navy officials being consumed by these claims to the detriment of other Navy work. You asked for recommendations.

2. I recommended that the Navy contract with outside firms who could assist the Navy in preparing its defense against these claims. I am convinced that the Navy cannot devote sufficient time, effort and talent to handle the claims properly and still carry out its primary functions. By contracting for this work, the Navy would be in a better position to see that the claims work is prosecuted by specialists on a coordinated and full time basis. The various claims cross so many organizations within the Navy that their evaluation is cumbersome and responsibility is diluted.

3. I recognize that what I am suggesting is different from the way Government agencies have typically handled these problems. However, the Government has never before been faced with anything approaching the magnitude and complexity of the shipbuilding claims that are being presented against the Navy today. When private companies are confronted with extensive litigation, they generally hire outside counsel even when they have attorneys on their staffs. In this way they can obtain the services of specialists and additional people to handle peak workloads and litigation without disrupting on-going work. But I am proposing something broader than just hiring outside attorneys.

4. A professional group of outside lawyers, technical personnel and procurement experts working full time could develop the capability to do much of the claims evaluation work better than it is being done today. This is not to say that Government employees are less intelligent than contractor personnel; it is just that they are overloaded and hampered by the system. In my own case, I found I had to go outside Government and procure nuclear design and manufacturing work from private industry. Only in that way have I been able to focus responsibility properly and direct the work. I believe the same benefits could accrue for the Navy if it subcontracted claims work. The Government would, of course, continue to guide the work, make the final decisions and, if necessary, present its own case in court.

5. The General Counsel disagrees with this approach and recommends hiring more Government lawyers to handle claims. After investigating the matter, he reported to you by memorandum dated April 12, 1973, that no one in the Navy has authority to hire outside counsel to handle claims asserted by contractors. He further stated that the Navy would get more for its money by hiring Government lawyers than it would by contracting with outside firms; that there are statutory restrictions regarding the hiring of outside counsel to represent the Government in litigation; that these restrictions could be construed as applying to claims prior to the institution of court action; and that statutory restrictions would effectively limit the pay of consultants to the Federal salary scale. He recommended that alternative solutions be explored in order to achieve adequate legal staffing within the Navy.

6. It is not apparent to me from the General Counsel's memorandum that all possibilities of getting outside assistance have been explored and are foreclosed by existing statutes. For example:

a. His memorandum gives the impression that outside assistance would have to be handled as a consulting arrangement where employees could not be paid more than Government employees. However, in other areas, the Department of Defense has been able to contract with consulting firms or other outside groups, such as the Logistics Management Institute, for specific jobs without limiting salaries to the Federal salary schedule. If these arrangements can be justified, it is not apparent to me why contracts for the preparation of legal and technical analyses, briefs and recommendations for the Government in the area of shipbuilding claims would run afoul of statutory restrictions on the hiring of consultants.

b. His memorandum addresses the legal problems involved with hiring outside counsel to represent the Government in a court of law. It states that in such cases, the attorney would have to be designated a Special Assistant Attorney General, and his compensation would be limited by law to $12,000. The memorandum does not say that the Attorney General is precluded from obtaining outside assistance when a Government attorney tries the case.

c. His memorandum states that the law could be construed to preclude contracting out for assistance in connection with claims because no court has ruled otherwise. The phrasing of this conclusion implies that the opposite construction is also possible.

7. Based on the above, I urge that the Navy make every effort to obtain outside assistance in working off the current claims backlog. In this regard I recommend the following:

a. The Navy should request a formal ruling from the Comptroller General as to the legality of a Navy contract with an outside firm for the purpose of analyzing specific claims, gathering data, preparing recommendations and the like. The contract would provide for technical and procurement support as well as legal assistance.

b. In the event the Comptroller General rules there is no legal way the Navy can obtain such assistance under contract, the Navy should request assistance from the Attorney General under Section 364 of the Department of Justice Act which, according to the General Counsel's memorandum, provides as follows:

> "Whenever the Head of a Department or Bureau gives the Attorney due notice that the interest of the United States require the service of counsel upon the examination of witnesses touching any claim, or upon the legal investigation of any claim, pending in such Department or Bureau, the Attorney General shall provide such service."

c. If the Attorney General concludes he is barred by statute from contracting for the requisite assistance, the Navy should propose appropriate legislation to permit such arrangements.

8. I would appreciate being advised of what action you take in this matter.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
The General Counsel of the Navy
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-2049

29 JUN 1973

MEMORANDUM FOR COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Hiring of Government claims team members by the Ingalls Shipbuilding Division of Litton Systems, Inc.

1. During the past year I have reported numerous instances of apparent improprieties by the Ingalls Shipbuilding Division of Litton Systems, Inc., in their financial dealings with the Navy. The major problems have involved excess progress payments and large unsubstantiated claims. In both cases, it appears that the company has submitted false and misleading information to the Government in support of its requests for payment. You appointed a special board to review these matters for possible violation of federal statutes.

2. I have just been informed of another matter that is relevant to the board's review. I understand that a member of the Navy claims review team at Pascagoula has announced that he is retiring from Government service and accepting a position with Ingalls Shipbuilding Division.

3. I believe it is improper for any company engaged in extensive litigation against the Government to offer employment to Government personnel involved in evaluating that company's claims and in preparing the Government's defense. Such offers place both the individual and the Government in an intolerable position. Moreover, it makes it more difficult for other Government employees to do their jobs properly, knowing that the contractor is a potential future employer. In total, it jeopardizes the Government's position in dealing with the contractor.

4. I recommend the following:

a. This matter should at once be brought to the attention of the NAVSHIPS Review Board and the NAVSHIPS Inspector General for a determination of any legal improprieties committed by Ingalls in offering a job to a member of the Navy's claims review team.

b. NAVSHIPS should issue a formal complaint to the President of Litton and insist that the company refrain from offering employment to Government personnel involved in awarding or administering contracts with the company, evaluating its claims, inspecting its products or currently involved in other business dealings with the company.

c. NAVSHIPS should review the overall situation at the Supervisor of Shipbuilding office in Pascagoula in particular, and at other private shipyards in general, to identify any other instances where companies have hired or offered jobs to Government personnel in sensitive positions such as those mentioned in sub-paragraph b. above.

5. I would appreciate being advised of what action is being taken in this regard.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Material
Naval Ship Systems Command Inspector General
Naval Ship Systems Command Counsel

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
0811-2075

31 OCT 1973

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Ingalls Shipbuilding Division, Litton Systems, Incorporated Claim Against the Navy Under Contract N00024-68-C-0342 for Construction of SSNs 680, 682 and 683

Ref: (a) NAVSHIPS Memorandum for Chief of Naval Material, Ser 0811-545 dtd 30 June 1972
(b) My Memorandum for Chief of Naval Material, Ser 0811-554, dtd 19 July 1972
(c) NAVSHIPS Memorandum for Chief of Naval Material, Ser 556-00J, dtd 28 Sep 1973

Encl: (1) Ingalls' Memorandum to File, dtd 17 Aug 1970, Subj: First Meeting on Repricing the Contract for SSNs 680, 682 and 683

1. Reference (a) forwarded a summary of the Navy technical evaluation of Litton Systems, Incorporated claim on SSN 680, 682 and 683 ship construction contract. Reference (a) stated:

> "There are indications that Litton has "backed into" its claim figure. The various claim proposals have been roughly equal to Litton's projected overrun. If Litton's present claim were allowed in full, it would turn a substantial loss under the contract into a substantial profit. In fact, Litton would obtain a higher profit than the initial target profit allowed in the contract. The major part of the claim consists of assertions, judgments, and allegations--unsupported by factual backup data. To overcome the lack of factual data supporting its claim, Litton has resorted to theoretical calculations and to what appears to be specious reasoning. From this, the NAVSHIPS technical review team was led to question Litton's good faith in its calculations of costs for the Government-responsible delay. It appears that Litton set out to obtain about $37 to $43 million from the Navy and developed its claim around those predetermined figures."

2. In reference (b) I summarized other facts that you and other senior Navy officials who may become involved in the claim should know. I also pointed out that in attempting to attribute these cost overruns to the Navy, Litton has, in my judgment, overstepped the bounds of propriety and that many elements in the claim appear contrived and are irreconcilable with facts contained in the company's own files. I recommended that the Navy investigate the claim to determine whether Litton's actions constituted a violation of the False Claims Act or of other federal statutes.

3. In reference (c), NAVSHIPS submitted the results of its formal investigation of the matter. With respect to the amount claimed, reference (c) states:

> "The relative constancy of the total amount sought from the Government despite the frequent varied and significant modifications to the elements of the total, lends credence to the belief that Ingalls pre-established a recovery objective of about $40 million and has manipulated the elements of cost to that end."

Reference (c) concludes there are reasonable grounds for believing that the claim is fraudulent and recommends that the matter be forwarded to the Department of Justice for more thorough investigation and for such further legal action as that Department deemed warranted inasmuch as the Department of Justice is the appropriate investigative activity to obtain access to additional documentary evidence from Litton files and to compel testimony from Litton employees.

4. Litton's claim is now before the Armed Services Board of Contract Appeals. Examination of Litton's files in conjunction with the Board hearing uncovered enclosure (1) which confirms that the amount of Litton's claim was predetermined by the projected cost overrun on the contract. In enclosure (1) Mr. R.A. Goldbach, Director, Division Planning is quoted as instructing those involved in preparing the claim as follows:

> "Mr. R. A. Goldbach discussed the requirements issued for repricing and made the following points:
>
> a. It is impossible to regenerate the original bid by account, and it would be of no benefit to Ingalls to do this. A gross discrepancy exists between the bid and the true world. It is also impossible to allot loss of learning by account, and it is impossible to state which account has been impacted by late GFE.
>
> b. Division Planning will provide an estimate of manhours to complete the contract. This estimate will be compared with the original of total manufacturing manhours to do the contract, and the difference will be justified in a saleable manner. The difference can be broken down by the end of August."

These statements confirm that, from the outset, Litton "backed" into the claim as we had suspected. That is, they calculated the projected cost overrun and then tried to develop a claim rationale that would blame the entire

overrun on areas of Government responsibility. Instead of being a legitimate effort to identify and price out the impact of Government responsible delays, the claim represents a deliberate attempt to reprice the contract, after the fact, without regard to legal or contractual entitlement.

5. In my view, enclosure (1) sheds light on the question of how the Litton claim was prepared. It also identifies some of the key Litton personnel involved in preparation of the claim. I recommend therefore that this memorandum and enclosure (1) be forwarded to the Department of Justice along with the NAVSHIPS report for use by that Department in its investigation of the claim.

6. I would appreciate being advised of what action you take in this regard.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations & Logistics)
Assistant Secretary of the Navy
(Financial Management)
Office of the General Counsel of the Navy
Commander, Naval Ship Systems Command

MEMORANDU

INGALLS EAST DIVISION ⊞ LITTON SYSTEMS, INC.

Serial No. 70-2420-24

DATE: August 17, 1970

O File

FROM: R. A. Page PHONE 4563

JBJECT: First meeting on Repricing the Contract for SSN680, 682 and 683

CC: R. A. Goldbach
F. G. Rubury

The first meeting concerning the repricing of the contract for SSN's 680, 682 and 683 was announced by Program Manager memo Ser. No. 70-2420-241 of August 7, 1970. The meeting was held in the Small Conference Room as stated by the memo. The following were present at one time or another:

G. M. Baggett	M. W. Hicks
T. L. Byers	J. Milandin
R. A. Goldbach	F. G. Rubury
F. B. Schultz	K. Verseckes
J. A. Serrie	W. B. Williford
G. A. Bobelis	S. D. Sutter
G. M. Byars	J. B. Rummels
J. H. K. Miner	C. A. Zemenick

The Program Manager chaired the meeting and briefly covered the following points in his opening remarks:

a. A schedule of events had been formulated and dates assigned. A firm schedule would be published by 8/21/70.

b. Progress reports would be issued weekly by the Program Manager.

c. Performance which had been experienced in generating the FOGY cost to complete and the cost to complete SSN's 680, 682 and 683 of last year would have to be avoided in the repricing. The published schedule must be met.

d. Among other reasons, it is essential to meet the submission date of November 1, 1970, because of the problems generated by Ingalls' delivery dates differing from government dates.

e. The requirements schedule was issued, and the meeting opened for general discussion.

Mr. R. A. Goldbach discussed the requirements issued for repricing and mad the following points:

Enclosure (1)

a. It is impossible to re-generate the original bid by account, and it would be of no benefit to Ingalls to do this. Agross discrepancy exists between the bid and the true world. It is also impossible to allot loss of learning by account, and it is impossible to state which account has been impacted by late GFE.

b. Division Planning will provide an estimate of manhours to complete the contract. This estimate will be compared with the original of total manufacturing manhours to do the contract, and the difference will be justified in a saleable manner. The difference can be broken down and justified by account. The estimate to complete will be available by the end of August.

Mr. F. G. Rubury submitted that the Navy probably has the bid broken down by account. Mr. Goldbach stated this was of no concern.

Mr. Goldbach stated that one estimate of manufacturing manhours would have to be done. It would include Quality Assurance and Nuclear Quality Assurance. Departments other than Division Planning should submit their estimates to Division Planning for inclusion in the overall bid.

Mr. Milandin raised the issue of dates to be used in the estimate. Mr. Goldbach and the Program Manager stated the dates were those published in the Master Construction Schedule and used in the submission for Financial Plan 71-1. The delivery dates are as follows:

680	3-1-73
682	9-1-73
683	3-1-74

These dates have been submitted to the Navy as Ingalls contract delivery dates.

Mr. J. A. Serrie questioned the necessity for him to be at the meeting. He stated his estimate to complete was identical to his 71-1 submission. Mr Bohelis and Mr. Schultz took essentially the same position. The meeting broke up, and the following remained for further discussion:

G. M. Baggett	M. W. Hicks
R. A. Goldbach	F. G. Rubury
G. M. Byars	K. Verrecke
W. B. Williford	J. H. K. Miner
C. A. Zemenick	(There was no representative remaining from Engineering and Material)

Mr. Goldbach stated that Ingalls would have to use that information and data which would sell. Any data which would not sell would have to be omitted.

Mr. Byers stated that Nuclear Power Division would provide a documented estimate to complete for Nuclear Engineering only. Estimates would not be provided by NPD for Nuclear cost centers outside of Mr. Slaughter's organization.

Mr. Baggett will review the material estimate to ensure it is in the proper form.

Mr. Zemenick stated that Finance, in order to get the cost to complete, required time phased manhours by superintendent in the same format as was used in Plan 71-1. He also requested that Finance be provided a business premise. The Program Manager said this would be the same as 71-1, and that he would provide written direction to Finance so stating. Finance also requires as much detail as possible including labor grades for Engineering, Nuclear Engineering, and Nuclear Quality Assurance.

Mr. Baggett requested Change Order be provided an account to which to charge for the effort involved in repricing. Mr. Zemenick stated he would investigate and try to provide a number.

R. A. Page

RAP:ef

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
MAT-00:ICK
00 memo 130-73
31 October 1973

MEMORANDUM FOR THE GENERAL COUNSEL OF THE NAVY

1. The original of the attached memorandum is forwarded to the General Counsel of the Navy for appropriate action in connection with other documentation on this matter already in the Office of General Counsel.

I. C. KIDD, JR.
Admiral, U. S. Navy

Att: NAVSHIPS memo to CNM 08H-2073 dated 31 Oct 1973

Copy to: (w/att)
ASN(I&L)
ASN(FM)
CNO
COMNAVSHIPS

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
08H-708

20 FEB 1974

MEMORANDUM FOR CHIEF OF NAVAL MATERIAL

Subj: Shipbuilding Claims

Ref: (a) NAVSHIPS Counsel Point Paper entitled "Shipbuilding Claims and Their Evaluation by the Navy," Ser 58 dtd 7 Feb 1974
(b) My Memorandum for CNM, Ser 08H-2042 dtd 14 June 1973

1. Reference (a) was prepared in response to a Deputy Secretary of Defense question as to whether the techniques used by NAVSHIPS for evaluating and resolving major shipbuilding claims are unnecessarily demanding and time-consuming and whether there are ways of simplifying the process, particularly with regard to evaluating delay and disruption claims. The purpose of this memorandum is to set forth my views which differ in several respects from those expressed in reference (a).

2. Reference (a) states that the claims problem results from contractor losses on shipbuilding contracts awarded during the past fifteen years and attributes these losses to matters over which the shipbuilders have no control; e.g. war, inflation, depletion of manpower, or Navy insistence on procurement by formal advertising. It leaves the impression that the shipyards have been victimized by economic events beyond the shipbuilders' control, but non-compensable under Navy contracts. Shipbuilders and their claims lawyers have been advocating this argument for years. I do not agree with it.

3. Other defense contractors have operated profitably under long term, fixed priced contracts in the face of the same wars, inflation, manpower shortages, and Department of Defense procurement policies, without resorting to claims. In the case of inflation, shipbuilders have an advantage over other defense contractors because shipbuilding contracts include a special escalation clause which increases the contract price in direct relation to increases in labor and material price indices. Moreover, no one, to my knowledge, has ever forced a shipbuilder to accept a contract. By entering into these contracts, shipbuilders have agreed to take the risks involved. Either they expected at the time of contract award to make a profit, or they engaged in a "buy in." In any event, the responsibility should not lie with the Government or its procurement policies if a contractor subsequently loses money.

4. In my opinion, the major reason for losses under shipbuilding contracts is poor shipyard management. During the past five years I have made formal reports of deficiencies in nearly all aspects of shipyard operations. The

following are typical of the problems I have pointed out which cause cost overruns, losses, or low profits at various shipyards: Ineffective cost controls and cost reporting systems; costs not related to progress in a manner that identifies potential overruns in time to take corrective action; subcontract procurements not managed in a business-like manner; excessive sole source subcontract procurements; superficial negotiations of subcontracts; poor productivity including widespread idleness and loafing; inadequate material controls; overtime not properly controlled; ineffective internal audit systems; excessive overhead costs. It is the responsibility of shipyard management to control these problems.

5. By and large private shipyards today are run, in effect, not by technical managers or experienced shipbuilders, but by legal, financial, and contract experts. These men are skilled in dealing with the Government, and proficient in public relations and "creative accounting." In general, they are not interested in the quality of ships or the difficult problems of production; they are interested in making money. Naturally, every company is in business to make a profit. But with the takeover of the shipbuilding industry by conglomerates, achievement of profit objectives transcends all else. Today, many top shipyard managers find that it is more profitable to let costs come out where they will, and count on getting relief through changes and claims; relaxation of procurement regulations and laws; Government loans; follow-on sole source contracts; and other escape mechanisms. As a result, shipbuilding has become largely a financial game.

6. Regarding the Deputy Secretary of Defense's question whether the techniques used by NAVSHIPS for evaluating and resolving major shipbuilding claims are unnecessarily demanding and time-consuming, I would answer yes. It is unnecessarily demanding because contractors can submit, revise and resubmit claims to the Navy, the Armed Services Board of Contract Appeals and the courts in an effort to recover some predetermined amount. It will continue to be unnecessarily time-consuming as long as the Navy must rely for claims defense work primarily on people who are inexperienced in evaluating claims, who are responsible for other ongoing work, and who receive little effective help or guidance in their claims evaluation efforts.

7. At the end of 1973, some 74 shipbuilding claims were pending either in NAVSHIPS or before the Armed Services Board of Contract Appeals. These claims totalled roughly $1.3 billion, about $350 million more than in 1972. I am particularly familiar with one of these claims--Litton's claim on the SSN 680, 682, and 683 ship construction contract. It illustrates what we are up against. Since November 1970, Litton submitted 5 different versions of this same claim prior to the Contracting Officer's decision, restructured the claim once more in its appeal to the Armed Services Board

of Contract Appeals, and then even revised it again during the Board's hearing. Each revision required extensive analysis and evaluation by Government personnel whose experience and primary responsibilities generally were in fields other than claims. This claim has consumed thousands of manhours of effort by technical, project, contract and legal personnel in the Navy--at the expense of important ongoing work. The Armed Services Board of Contract Appeals is still conducting hearings on this case. Even if the Navy gets a favorable ruling by the Board, the Contractor may elect to take the case to a federal court. Thus the end is not even in sight.

8. The claims litigation circuit is inherently time-consuming. A contractor has no incentive to drop a claim as long as he anticipates receiving enough additional money on appeal to cover his litigation costs. Usually he can collect what he wins at each level. If the contractor persists long enough, the Government may eventually agree to a higher settlement to escape the nuisance of further litigation. Moreover, at each higher level of appeal, there is less familiarity with the details and therefore more likelihood of a compromise decision. Since the Government does not appeal adverse decisions of the Armed Services Board of Contract Appeals, anything the contractor wins there, is his to keep. So he risks little or nothing and has everything to gain by continuing to prosecute a claim.

9. In my opinion, the Navy's claims effort to date, although substantial, has not been adequate to meet the problem. In an attempt to defend better against claims, the Office of the General Counsel established a separate Contract Appeals Division to handle cases before the Armed Services Board of Contract Appeals. NAVSHIPS established a special claims evaluation group at Pascagoula to work on Litton claims. In December 1973 the special claims group at Pascagoula alone had about 70 people, 40 clerical and 30 professional. Most of the 30 professionals were SUPSHIP employees, temporarily detailed to the claims group, who had little or no expertise in evaluating claims. Because many assignments to the claims group are temporary and turnover is high, little permanent capability has been developed for future claims. In addition there has been a lack of coordination among the Pascagoula claims evaluation group, the Contract Appeals Division, and NAVSHIPS project, contract, legal, and technical personnel. As a result, NAVSHIPS technical and project personnel inexperienced in claims matters have had to formulate much of the substance and strategy of the Navy's case for the SSN 680 claim both before and during the trial. Because the Government people working on the claims are neither experienced nor well directed, much of their work has been unproductive.

10. Despite shortcomings in the Navy's handling of the SSN 680, 682, and 683 claim, that claim probably has received far more attention and effort than many larger claims in the Navy's $1.3 billion backlog. It is obvious to me that the Navy cannot sustain a comparable effort on the 73 other unresolved claims without effectively destroying our ability to build and maintain ships.

11. In March, 1973 you called a meeting of senior Navy procurement, technical and legal officials and expressed concern at the large backlog of Navy shipbuilding claims, the amount of effort required of key Navy personnel to process these claims, and the likelihood of having to cancel ships if the Navy could not successfully defend itself against these claims. I recommended then that the Navy concentrate on developing a professional group of outside lawyers, technical personnel, and procurement experts, who could work full time on claims evaluation and case preparation for the Navy. The Navy General Counsel at that time, Mr. Mankin, was convinced that the problem could be solved by hiring more Government lawyers and subsequently wrote a memorandum to that effect. In reference (b) I explained why hiring more Government lawyers would not do the job. Under the present system, the Navy cannot devote sufficient time, effort and talent to handle claims properly and still carry out its primary functions.

12. I recognize that NAVSHIPS has contracted for outside technical assistance to help evaluate certain aspects of the Litton claims. This is not enough. The Navy needs to develop a full-time professional claims group outside the Government to handle claims. The vast extent of claims renders such a method essential. The Government would have to guide the work, make decisions and perhaps represent itself in court but most of the work should be performed by outside experts.

13. It is clear that the Navy is not itself equipped to handle the claims problem. Litton's AE (Ammunition Ship) claim (about $37 million) is about to be litigated. The Navy is behind schedule in preparing its defense on Litton's "Project X" or "Impact" claim (about $100 million). Although this claim was submitted to the Armed Services Board of Contract Appeals in August 1972, the Navy recently had to ask for a six-months delay in the trial date which had been set for May 1974. The claims group at Pascagoula is now trying to acquire additional people to work on these claims.

14. To maintain the integrity of existing contracts, the Navy cannot afford to let shipbuilders reprice loss contracts through the guise of claims. Since several shipbuilders seem determined to shift the responsibility for their overruns to the Navy no matter what the circumstances, we must organize properly so that we can defend against unwarranted claims without jeopardizing our primary responsibilities. As a first step and test case, I recommend that the Navy contract with a group of outside lawyers, technical personnel and procurement experts to coordinate and prepare the Navy's defense on Litton's "Project X" or "Impact" claim. This is a large and complex claim, involving issues of principle which, if not handled properly, could set unfavorable precedents and open new bases for claims at other shipyards. It deserves the best talent the Navy can obtain.

15. I would appreciate being advised of what action you take in this matter.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
The General Counsel of the Navy
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
08H-742

26 JUL 1974

MEMORANDUM FOR THE GENERAL COUNSEL, OFFICE OF THE SECRETARY OF DEFENSE

Subj: Use of Outside Counsel to Assist the Navy in Defending Against Shipbuilding Claims

Encl: (1) My memorandum dtd 10 May 1971 for the General Counsel of the Navy; subj: Shipbuilder claims (Encl (1) to Encl (3), below)
(2) My memorandum dtd 11 Feb 1972 for the Chief of Naval Material; subj: Claims procedures (Encl (2) to Encl (3) below)
(3) My memorandum Ser 08H-558 dtd 9 Aug 1972 for the Chief of Naval Material, subj: Recommendations for improving Navy claims procedures based on experience gained from Litton Systems, Inc., Ingalls Nuclear Shipbuilding Division, claim against the Navy under Contract N00024-68-C-0342 for construction of SSN's 680, 682, and 683
(4) My memorandum Ser 08H-2042 dtd 14 June 1973 for the Chief of Naval Material, subj: Obtaining outside assistance in defending against shipbuilder claims
(5) My memorandum Ser 08H-708 dtd 20 Feb 1974 for Chief of Naval Material, subj: Shipbuilding Claims
(6)

(7)

(8)

(9)

(10)

(11)

08H-742

1. At our meeting on July 10, 1974, you asked that I summarize my views on major shipbuilding claims, with particular emphasis on why I recommend greater use of outside counsel to assist the Government.

2. In enclosures (1) through (5) I have reported to various Navy officials problems associated with shipbuilding claims as I see them and my specific recommendations for corrective action. In short the problem is this: Shipyard management attention today is focused primarily on legal, contractual, and financial matters rather than on technical and production problems. With the takeover of shipyards by conglomerates many top shipyard managers have found they can compensate for their own management or production problems and devote their primary effort toward getting relief through changes and claims, or by trying to force relaxations of procurement regulations and laws. Some shipbuilders begin establishing the basis for a large claim from the early days of contract performance in case they run into problems later. Often they assemble teams of experienced lawyers, accountants and engineers to accomplish this.

3. In cases where a shipbuilder incurs a substantial loss or fails to make his desired profit, he may submit a large claim to make up the difference. Often the claims consist of general allegations, but the Navy ends up with the burden of trying to determine whether the shipbuilder is entitled to any additional sums and if so, how much. This process can take years and tie up hundreds of hours of top technical, legal, and contractual people on the part of the Navy. If the Navy gathers evidence that disproves an element of the claim, the shipbuilder can delete that item and substitute another allegation so that the claim does not get below the desired amount. All the while, the shipbuilder complains to senior Department of Defense officials about the "unreasonableness" of the Navy personnel charged with responsibility for evaluating the claim. These are precisely the tactics the Navy encountered in the Litton Systems, Incorporated, claim under the SSN 680, 682 and 683 shipbuilding contract.

4. Enclosures (6) through (11) are memoranda I sent to my superiors describing the problems we faced in the Litton claim. I urge that you read them carefully. This case is an excellent illustration of the difficulty in effectively fighting against unwarranted claims, and why the Navy needs to develop a professional group of outside lawyers, technical personnel, and procurement personnel working full time to do claims evaluation work. The Navy cannot devote sufficient time, manpower, and resources to handle major shipbuilding claims properly and still carry out its primary functions. Expected reductions in Navy personnel will further aggravate the problem.

5. I was recently exposed to outside counsel in connection with an important defective pricing case involving a subcontractor under several cost reimbursement prime contracts for naval nuclear equipment. The subcontractor filed suit in District Court in an effort to dissuade the Navy from pursuing the defective pricing issue. Since the dispute arose under cost reimbursement prime contracts, the Navy had a direct financial interest in the outcome of the case as well as a duty to enforce the Truth-in-Negotiations Act (P.L. 87-653).

6. Initially the Government's interests were represented by the prime contractor's counsel, Covington and Burling. However, to preclude any possibility of a conflict of interest arising where the Government's interests might be different from prime contractors, the Navy General Counsel arranged for the prime contractor to retain at Government expense another outside law firm, to represent the Navy in one count of the lawsuit. The firm of Ruckelshaus, Beveridge, and Fairbanks was selected.

7. Because of these special arrangements, my staff dealt directly with both outside law firms. I was favorably impressed by their competence and efficiency. Both firms assigned experienced trial counsel to the case.

8. Outside counsel were especially effective during the discovery phase of proceedings. They helped formulate a plan of attack, took the initiative in interviewing potential witnesses, and in drafting subpoenas and interrogatories. My staff was in the position of reviewing well prepared drafts, rather than having to do much of the preliminary work themselves as is often the case when I must rely solely on Government attorneys who are overloaded and hampered by the system. Outside counsel responded quickly, in a matter of days and sometimes hours, to each maneuver by plaintiff. Their prompt action prevented an attempt by plaintiff to suspend the suit in district court and to move the case to the Armed Services Board of Contract Appeals, a move which the Government opposed. Working with these two firms was a most satisfactory experience.

9. The final result, in which the advice and action of outside counsel played a significant role, was that the subcontractor proposed a satisfactory settlement of the outstanding issues, and as a part of that settlement, dismissed the suit in district court. Thus the Government avoided a long and costly lawsuit. This experience has reinforced my judgement that use of outside counsel in proper circumstances, is a wise course to follow. Large corporations with in-house legal staffs, do not hesitate to hire outside counsel when facing major litigation. Neither should the Government.

10. You asked that I recommend two cases involving shipbuilding claims in which to test the use of outside counsel. My recommendations are:

a. The $100 million Litton so-called "Project X" Claim (ASBCA #17579). This is a large and complex claim. It presents a legal theory which has never been recognized by the Navy and, if Litton succeeds, will have a profound impact on shipbuilding claims. It would open a new basis for recovery at other yards and lead to a new round of multi-million dollar litigations.

In 1970 Litton filed a protective suit in the Court of Claims (No. 302-70); an appeal to the Armed Services Board of Contract Appeals was filed in August 1972. The Navy is handling the case with in-house counsel but has

not been able to provide the necessary continuity or support. The chief trial counsel has been changed three times in the past year, the most recent change being made this month. Legal assistance has been on a part time basis. The Navy has been trying to recruit additional attorneys to assign to the claim, but at the salaries the Government offers, it is not possible to hire top flight, experienced trial lawyers. In my opinion, this case is too important to turn over to new hires and trainees. I believe the Government should retain outside counsel to help focus the issues and direct the strategy in this claim, under Government supervision of course.

b. The Newport News claim under Contract No. N00024-68-C-0355 for construction of the DLGN's 36 and 37. This represents an opportunity to test use of outside counsel at an early stage in the development of the claim. Newport News has already submitted a series of claims totaling about $54 million, a major portion of which relates directly to Naval Reactor business. The Navy expects six to eight million dollars of additional claims to be filed against this contract. Our technical evaluation is that these claims are grossly inflated but that they approximate the amount of the Newport News projected overrun plus profit. I believe that if we hired outside counsel, and adequate supporting technical personnel, the Department of Defense could save millions of dollars. If we do not convince the contractor that the Navy can and will enforce its contractual rights, we shall be plagued with this and similar claims for many years to come.

11. In summary the Navy cannot devote sufficient time, manpower, and resources to handle major shipbuilding claims properly and still carry out its primary functions. The Navy has been forced to rely primarily on people who are inexperienced in evaluating claims, who are responsible for other ongoing work, and who receive little effective help or guidance in their claims evaluation efforts. The various elements of claims defense cross so many different command and organizational lines that review of claims and preparation for defense are unnecessarily cumbersome and time consuming.

12. I believe it is both practical and essential that the Navy develop a professional group of outside lawyers, technical personnel and procurement experts working full time to do the claims evaluation work and that such action would substantially enhance the Navy's ability to ensure that contractors are paid no more than they are entitled to under their contracts. The Government would, of course, continue to be responsible for guiding the work, making final decisions and, if necessary, presenting its cases in court.

13. As long as shipbuilders believe they can be reimbursed for their own ineffectiveness and mistakes through claims the Navy will continue to have massive claims, shipbuilders will not have the incentive to improve their efficiency, and the price of ships will continue to skyrocket. If this trend continues, we will not be able to afford the ships we must have to defend our country adequately.

08H-742

14. I would appreciate being informed of what action you intend to take in this regard.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Material
The General Counsel of the Navy
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
08H-739

26 JUL 1974

MEMORANDUM FOR THE GENERAL COUNSEL, OFFICE OF THE SECRETARY OF DEFENSE

Subj: Chu Associates decision; need to appeal

1. In our meeting on July 10, 1974, we discussed briefly the Wunderlich Act, 41 USC 321,322. I expressed my conviction that the Government should have the same right of appeal from adverse decisions of the Armed Services Board of Contract Appeals as contractors have. This memorandum is submitted in accordance with your request.

2. Recently the Naval Sea Systems Command attempted to present a defective pricing case which arose under one of my contracts. A subcontractor failed to submit data which, in our opinion, was required to meet the criteria of the Truth-in-Negotiations Act (P.L. 87-653). In defense, the subcontractor cited the case of Chu Associates, Inc. Armed Services Board of Contract Appeals 15004 (1973). In that case the Armed Services Board of Contract Appeals held that the contractor was not obliged to disclose a lower supplier quote to the Government under the Truth-in-Negotiations Act as long as he did not intend to use that quote at the time he signed the certificate of current cost and pricing data. This was held to be so even though the contractor subsequently contracted with that supplier and realized a large wind-fall profit thereby.

3. This was the very evil which prompted passage of the Truth-in-Negotiations Act in the first place. The Chu case and other decisions of the Armed Services Board of Contract Appeals which follow it, have rendered the statute virtually ineffective. The issue of what constitutes "data" in the context of the Truth-in-Negotiations Act is a question of statutory interpretation, and would seem to be appropriate for appeal to the Court of Claims. The final determination of law in this matter should not be made by an administrative judge on the Armed Services Board of Contract Appeals.

4. As you are aware, the recent Supreme Court decision, S&E Contractors, Inc. v United States 406 US 1 (1972) is widely thought to hold that the Government cannot appeal from an adverse ruling of the Armed Services Board of Contract Appeals. However, at least one high Justice Department official has expressed publicly the opinion that an agency has the right of appeal from a decision of its own Board of Contract Appeals. He believes the S&E case holds only that the General Accounting Office and the Justice Department (or any other outside agency) may not intervene and prevent an agency from paying a contractor in accordance with a decision of its Board of Contract Appeals when it desires to do so.

5. The Chu decision, if it is not reversed, has the effect of rendering the Truth-in-Negotiations Act almost useless in protecting the Government in sole source price negotiations. All a contractor has to do, when caught withholding important and relevant cost or pricing data, is to claim he never intended to use the information at the time he signed the certificate. The burden of proof then shifts to the Government to disprove that contention or lose its right to a price reduction. Obviously there will be few cases in which the Government will have the evidence to prove the contractor intended to use certain cost data when he testifies he did not intend to use it.

6. Even apart from the Chu decision, the need for the Department of Defense to have the right to appeal from adverse Armed Services Board of Contract Appeals decisions is important because of the magnitude of claims being decided by that Board and the complexity of the issues in some of those cases, especially in the multi-million dollar shipbuilding cases. These cases should not be finally decided by an administrative judge with only one party enjoying the right of appeal.

7. I recognize that legislation is now before Congress to clarify the Wunderlich Act to make explicit the Government's right of appeal. The Department of Defense should support that provision of the proposed legislation. But the legislative process could take many months and passage is by no means certain. Therefore, I recommend that the Department of Defense appeal the Chu decision, or the next appropriate appeal case following Chu, using the Department of Justice theory that an agency may appeal adverse decisions of its own Board of Contract Appeals.

8. I would appreciate being informed of what action you intend to take in this regard.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Material
The General Counsel of the Navy
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
08

16 OCT 1974

MEMORANDUM FOR THE GENERAL COUNSEL OF THE NAVY

Subj: Contracting for Outside Counsel

1. Since 1971, I have been recommending that the Navy contract with outside attorneys to assist the Navy in handling its billion dollar backlog of shipbuilding claims. The Office of the General Counsel, Navy simply did not have and still does not have the necessary resources to handle this backlog properly.

2. From the outset, the Office of the General Counsel opposed obtaining outside counsel, wrote legal memoranda questioning the legality of such action, and indicated that OGC had the situation under control. However, I believe you recognize that the situation is still not under control. There remains a large backlog of shipbuilder claims. There is a high turnover of Government attorneys working in the claims area; their experience level is low. In contrast, shipbuilders are contracting with prestigious law firms for experienced attorneys to develop and prosecute these claims.

3. In my memorandum dated 26 July 1974 to the General Counsel, Office of the Secretary of Defense, I reiterated the importance of obtaining outside counsel to assist the Navy in defending against shipbuilding claims. In that memorandum I recommended that the Navy obtain outside counsel to assist with claims developing at Newport News. You subsequently agreed to contract for outside counsel at Newport News. However, since that time NAVSEA efforts to award such a contract have been thwarted by your office. Despite repeated personal commitments from you as to when you would have such a contract, all of which you have missed, we are no closer today to having a contract than we were six weeks ago. Moreover, it has been impossible to deal effectively with your subordinates, since they apparently have been instructed that you are handling this matter personally.

4. I can only conclude from your procrastination that you do not wish to act on this contract. In contrast, your counterparts in the shipbuilding business have not hesitated to hire outside counsel who are claims experts to direct preparation of their claims and to present them. As long as shipbuilders believe they can be reimbursed for their own ineffectiveness and mistakes through claims, the Navy will continue to have massive claims, shipbuilders will not have the incentive to improve their efficiency, and the prices of ships will continue to skyrocket. This is why you should act now to obtain assistance through outside counsel.

5. Obviously, you are unwilling to act in this matter. Therefore, I suggest you assign authority to act to one of your subordinates and withdraw personally so that this matter can proceed. Please let me know what action, if any, you intend to take in this matter.

H. G. Rickover

Copy to:
Secretary of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

4 DEC 1974

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Exercising of Options with Newport News for Construction of DLGN 41 and 42

1. I understand that Newport News officials have been trying to solicit your support for not exercising the DLGN 41 and 42 options; or, for granting extra-contractual relief under Public Law 85-804 so that the option prices would assure Newport News a 7% profit on actual total costs.

2. Here is some information you should know:

a. NAVSEA has legal and binding options for the DLGN 41 and 42. Both Newport News and Congress have been notified that the Navy intends to exercise the DLGN 41 option in the immediate future.

b. As late as December 1973, the President of Newport News agreed to extend the priced option for DLGN 41 until 1 February 1975 and for DLGN 42 until 1 February 1976.

c. The options provide for negotiation of revised escalation tables so that Newport News is not hurt by inflation. To date Newport News has not submitted its proposal for these new tables.

d. Granting extra-contractual relief prior to contract performance would set a precedent that the Navy does not intend to require companies to honor their contracts. Other contractors would undoubtedly demand comparable treatment whenever they want to reprice a Navy contract. It certainly would open the door to reprice every other shipbuilding contract at Newport News.

3. NAVSEA has been making every effort to require Newport News to honor its contracts and your support in this regard is essential. NAVSEA's efforts would be undermined if Newport News were to get the impression that the NAVSEA position is not being supported by higher Naval officials. Therefore, if Newport News or Tenneco officials continue to contact you on this subject, I recommend that you refer them to NAVSEA, so that the company clearly understands with whom they are to deal.

H. G. Rickover

Copy to:
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C 20362

IN REPLY REFER TO

31 January 1975

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY
(INSTALLATIONS AND LOGISTICS)

Subj: Memorandum of Understanding Concerning Exercise of DLGN 41 Option

1. I appreciate your calling me this morning to inform me that the Navy would exercise the option for construction of the DLGN 41 and informing me that the Navy General Counsel had entered into a Memorandum of Understanding with the Newport News Shipbuilding and Dry Dock Company General Counsel concerning the exercise of this option. As you know, I was not involved in the preparation of the Memorandum of Understanding.

2. Subsequent to your call I obtained a copy of the Memorandum of Understanding which becomes effective on 3 February 1975. From my reading of the document, I am concerned that company officials may represent to our superiors in the Defense Department or to other Navy officials that the Memorandum of Understanding obligates the Navy to reopen the entire DLGN 41 contract for renegotiation rather than only those provisions subject to negotiation in accordance with the terms of the option. That would be inconsistent with the position that the Naval Sea Systems Command and the Office of Navy General Counsel have previously taken with Newport News - a position with which both you and Admiral Kidd have indicated agreement.

3. I understand a meeting is scheduled early next week between Mr. N. W. Freeman of Tenneco and the Deputy Secretary of Defense and that you may be present. I consider it important that those of us in the Department of Defense who have responsibilities regarding the DLGN 41 contract have a common understanding of the meaning of the agreement prior to that meeting.

4. My understanding of the Navy's intent with respect to this agreement is as follows:

a. The Navy has unequivocally exercised the DLGN 41 option and considers that option to be valid in all respects.

b. The Memorandum of Understanding is not a contractual document and does not prejudice any Government rights as reflected in the DLGN 41 option.

c. The Navy's obligation under the agreement "... to negotiate in good faith to reach an agreement as rapidly as possible to modify those contract provisions requiring amendment or to take other appropriate action" is limited to (1) those items which are open for adjustment by terms of the DLGN 41 option and, (2) any equitable adjustments to which Newport News may be entitled by the present provisions of the contract including the exercised option for DLGN 41.

d. The Navy considers Newport News is contractually obligated to proceed with construction of DLGN 41 as required by the option rather than just continue with long lead effort previously authorized.

5. The position of the Naval Sea Systems Command would be jeopardized if Department of Defense officials took a position inconsistent with that outlined in paragraph 4 above. Therefore, I urge that you stress these points to the Deputy Secretary of Defense prior to his meeting with Mr. Freeman next week. In addition, I recommend that the Naval Sea Systems Command, which has primary responsibility for the Navy's contracts with Newport News, be represented at that meeting, since Mr. Freeman will doubtless raise contractual issues.

H. G. Rickover

CC:
Chief of Naval Material
Commander, Naval Sea Systems Command
Navy General Counsel

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
08

4 FEB 1975

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS)

Subj: DLGN 41 Option

1. In my memorandum to you of 31 January 1975, I expressed my understanding of the Navy's intent with respect to the Memorandum of Understanding that Navy and Newport News counsel signed in connection with exercise of the DLGN 41 option.

2. Your 3 February 1975 response stated you are in general accord with my views. However, I am concerned that there may be some misunderstanding of my views. Your memorandum stated that in our telephone conversation the morning of 31 January we agreed that modification of the contract would be required. The option does require some specific modifications to the contract. However, I am concerned that you may have thought I contemplated contract changes beyond this.

3. If in any discussions with you I conveyed the impression that I agreed with modification of the DLGN contract other than as specifically provided for by the provisions of the present contract including the exercised option for DLGN 41, this impression was certainly unintentional and is not in accord with my views on the matter. For example, I do not agree we should remain firm only "in those areas where our rights are unquestioned" since Newport News has repeatedly challenged the validity of the DLGN 41 option in its entirety. Moreover, you state you hope we will "remain flexible in those areas where changes have occurred which are beyond the control of Newport News or the Navy."

4. However, Newport News has proposed extensive contract modifications which would in effect reform the options for DLGNs 41 and 42, arguing that the present contract arrangement would result in a loss to Newport News for reasons beyond its control.

5. In my opinion, the Navy should not excuse Newport News from its contractual commitments when hundreds of other contractors are required to honor their contracts.

6. I recommend that negotiations be limited to those areas specifically left open by the terms of the DLGN 41 option and to equitable adjustments to which Newport News is entitled by contract.

H. G. Rickover

Copy to:
Chief of Naval Material
The General Counsel of the Navy
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
14 February 1975

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS)

Subj: Meeting to Discuss Forthcoming Negotiations of DLGN 41 Option With Newport News Shipbuilding and Dry Dock Company

1. The purpose of this memorandum is to fulfill my commitment to you to provide the attendees of the subject meeting held in your office on the afternoon of 10 February 1975 with a copy of the comments I made at that meeting from rough notes.

2. You will recall that following your introduction and comments by others present, I made the following points regarding the Navy's treatment of the overall Newport News problem, particularly as it affects the present refusal of Newport News to honor the DLGN 41 option:

a. In my opinion a major source of our present difficulty in dealing with Newport News is the manner in which Navy and Defense officials have discussed contractual matters with the contractor. I know of no contractor who has had the opportunity to deal on the same issue simultaneously with so many high Government officials. I know of no other contract where so many senior Defense and Navy officials have participated in the issue. I know of no other contract where the responsible NAVSEA director of contracts has been bypassed so many times, and not even permitted to attend meetings held on matters which are his responsibility.

At the subject meeting you stated that all negotiations concerning the DLGN 41 option are to be handled by Rear Admiral Renfro and that all contacts with the contractor are henceforth to be made through him. I agree with that position.

b. I reiterated my position, which I understand is consistent with your position, that the negotiations for the DLGN 41 option should be confined to those things for which the Government is responsible under the present contract, including the open items in the option. The Navy is in an excellent legal position regarding this option and should not make concessions because of the Newport News threat of going to court.

c. The option has been exercised, and is now part of the DLGN 38 Class contract. I stressed the importance of recognizing that any special considerations offered by the Government on this option could well be used by the contractor as a precedent for reopening similar issues for the DLGN 38, 39, and 40 and other contracts.

d. I noted that Newport News may well be facing serious financial difficulty in relation to their new commercial yard. They may be looking for a way to transfer some of these costs to Navy contracts.

Subsequent to Newport News announcing construction of the new yard without prior notification to the Navy, Company officials assured the Navy in writing that the new yard would be a separate organization. However, the organization changes announced by Newport News on 25 January 1975 include changes which appear to have the effect of amalgamating the new yard with the old yard into one organization. In the production planning, scheduling and waterfront work areas managers responsible for meeting commitments on Navy contracts are now also responsible for meeting commitments on commercial construction contracts. This certainly will make it harder for the Navy to tell when individuals are being transferred from Navy to commercial work. Clearly Newport News would like to find a way to abrogate the February 12, 1973, letter from Mr. Freeman to me which agreed to the policy that "Tenneco will not allow performance of work on non-Navy contracts to interfere with the performance of work necessary to meet Newport News commitments on Navy contracts." In fact, with the yard's senior production managers responsible for Navy ship construction now also responsible for commercial ship construction, I don't see how it is possible for commercial work not to interfere with Navy work.

e. I pointed out that we used to have periodic financial meetings among SUPSHIPS, Defense Contract Audit Agency representatives, my representatives, and Newport News. At one of the early meetings of this type Mr. Ackerman agreed in writing to provisions for accounting for the costs of the commercial yard which would protect the Navy from absorbing these costs. Newport News has for some time been trying to discredit my financial representative at Newport News and has succeeded in getting the support of the Chief of Naval Material to abolish these periodic meetings. I have tried unsuccessfully, orally and in writing, to obtain from the Chief of Naval Material a statement of the basis for the complaints made against my financial representative. Part of the motivation to discredit

my financial representative and these meetings may be to build a case for withdrawing the agreements made by Mr. Ackerman concerning cost accounting for the new yard. This remains to be seen; but certainly fits the pattern followed by Newport News and Tenneco officials in their dealings with top level Defense and Navy officials. Their recent attempt to discredit Mr. Leighton and myself, as discussed in Rear Admiral Renfro's memorandum of 7 February 1975, is another example of their use of this tactic.

One of the favorite techniques of some contractors is to gain access at as high a level in the Government as possible and to complain about the actions of the lower level Government officials who have day-to-day dealings with the contractor. The theory is that the high level Government officials are inherently suspicious of the working people in the bureaucracy and will not believe them even if the officials do take the time to try to ascertain the facts.

You are probably well aware of the fact that Mr. Corcoran, the Washington lobbyist who represents Tenneco, has over a period of many months circulated derogatory stories about me at high levels of Government both in the executive and legislative branches. It certainly comes as no surprise to Mr. Leighton or to me that Newport News wants Mr. Leighton to have no part in the DLGN 41 negotiations. They know full well that he is the only person left in NAVSEA who participated directly in the negotiations of most of the present Newport News contracts and that he is intimately familiar with the various commitments Newport News and Tenneco officials have made to the Navy. Further, Newport News knows that if they can intimidate the Navy into silencing Mr. Leighton and me, no one else in NAVSEA is likely to raise his voice to oppose them.

f. I noted at the meeting that as part of the DLGN 41 negotiations Newport News wants to delay the contract delivery date for the DLGN 41 by 19 months and for the DLGN 42 by 23 months. This would put 29 months between delivery of the DLGN 40 and the DLGN 41 rather than the 8 to 10 months between ships that Newport News has heretofore stated is the most economical delivery. This could well be an attempt on the part of Newport News to reprice the contract as well as to divert skilled manpower from the frigates to commercial ship construction. If the Navy accepts the later contract delivery dates proposed by Newport News, the Navy must be prepared for Newport News to assert that the Government should fund increased manhours due to the break in ship production and loss of learning. Also, if the skilled manpower is diverted to

commercial work, the Navy could then find itself charged for the cost of training new employees when the frigate work started again with DLGN 41.

g. I stated that Tenneco and Newport News officials have frequently alleged that they were forced during negotiations to accept unsatisfactory pricing agreements because Congress had not appropriated sufficient funds. They have suggested that this could be a basis to reopen price agreements and give them more money. This is simply not so.

In the case of the four follow SSN 688 Class ships and the last two ships of the STURGEON Class, which account for about two-thirds of the loss Newport News has reported in their financial statements to the Navy to date, both contracts were awarded on a strictly competitive basis with three bidders. There were no negotiations of the contract prices for these two contracts whatsoever.

In the cases of the DLGN 36-37 contract, the DLGN 38 Class contract, the CVAN 68-69 contract, and the SSN 688 lead ship contract - all of which were negotiated on a sole source basis with Newport News - ceiling price provisions were included in the contracts which gave Newport News price protection beyond their expected costs. On several of these contracts the ceiling price provisions included in the contracts were well beyond the funds appropriated at that time, and the Navy went back to Congress for additional funds to pay for the Government's obligation of costs on the share lines when that was found to be necessary. This in itself is proof that the amount of money allowed in the contracts was not restricted to the appropriated funds. In each of these cases target price was higher than the Government's estimate of what the costs should have been, but was within the amount of appropriated funds. Thus the "full funding" requirements of the Congress were met, while at the same time Newport News was given financial protection to the degree they considered necessary at the time they signed the contracts.

h. The Newport News 48 page legal brief recently submitted to NAVSEA which states their view that the DLGN 41 option is invalid is based in large extent on a presumption that the costs will be so much greater than those allowed under the contract that performance under the contract would amount to "commercial impracticability." You confirmed at the meeting that Mr. Freeman stated Newport News would incur a $60 million loss if they built the DLGN 41. Admiral Kidd said that

Mr. Freeman later amended this statement to say that the $60 million loss would be for both the DLGN 41 and DLGN 42. Yet the official cost reports for the DLGN 38 Class submitted to the Navy for billing purposes would indicate that Newport News could expect to make a profit on the DLGN 41 and DLGN 42 within the current contract pricing envelope and contract delivery date.

When Newport News extended the current options for the DLGN 41 and DLGN 42 in November 1973 they informed NAVSEA that they were projecting costs below the Point of Total Assumption on the cost share line provided in the option. This, of course, was based on building the DLGN 41 and DLGN 42 in series with the DLGNs 38, 39, and 40. In my opinion the Newport News forecast of losses on the DLGN 41 and DLGN 42 is based on their desire to delay these ships in order to transfer the manpower now working on frigates to other work. This delay would cause loss of learning and additional escalation costs caused by delay. It is also clear that Newport News wants the Navy not only to pay these added costs but to pay them the same profit they had originally expected to make as well.

i. I pointed out that Newport News and Tenneco officials frequently complain that they have to pay large interest charges to finance Navy work. In this regard I noted that as of early February 1975 Newport News reported costs totaling $1,471M on open new construction Navy contracts and they have been paid $1,408M, a shortfall of $63M.

However, their shortfall on the SSN's 686 and 687 is $25M and on the four follow SSN 688 Class is $21M for a total of $46M. These were competitive bid contracts and Newport News has thus far not submitted any claims against these contracts. These ships account for most of their overall cash shortfall to date; this is not a Government responsibility.

On the CVAN 68-69 contract Newport News has received $20M more than they have expended.

On the DLGN 36-37 contract Newport News has a present shortfall of $16M. On the DLGN 38-40 contract Newport News has a present shortfall of $12M. On the SSN 688 lead ship contract Newport News has a present shortfall of $9M. Newport News has not submitted justification showing these cash shortfalls to be Government responsibility.

j. I stressed that no complete formal minutes of meetings between Company and Navy officials have been furnished to the

contracting officer and to others responsible. Because of this we often find ourselves in the position of being unable to challenge the contractor when he refers to agreements he may have made with our superiors - agreements to which we were not party, and of which we are not aware. Subordinates in the contract and shipbuilding process have been demoralized because their seniors have preempted their responsibilities, and decisions appear to be made without adequate facts, or their knowledge or advice. I am getting the impression that the need for ships and a healthy defense industry may be being used as the excuse for making liberal contractual settlements on claims.

Frequently I learn after these meetings of contractors with my superiors that allegations against me and individuals in my organization have been made by the contractor officials. I nearly always learn of these through gossip, not through direct statements to me by my superiors. By that time the damage has been done, and I was not afforded the opportunity to comment on the charges. I cannot help but wonder whether the order given to me several months ago by the Chief of Naval Material to confine my activities solely to the areas of my direct responsibility, and his request that I assign Mr. Leighton's responsibilities to another person, were not the result of credence being given to unsupported allegations of Newport News and Tenneco officials. I am fully aware of Mr. Leighton's activities in regard to dealing with Newport News and I accept full responsibility for them. They are professional, knowledgeable, fair, legal, and in the best interests of the Government. In my opinion he has done and is doing as outstanding a job in looking out for the public's interest as anyone I know. I would think the Navy would therefore particularly value his services.

k. I have frequently been urged by the President, Congress, SECDEF, the Navy, and other superiors to conduct business at minimum cost to the United States. Yet, I find that in dealings with this contractor my superiors give him reason to believe that his requests for additional money and for relief beyond the terms of his contracts will be given favorable consideration in contract negotiations. I made it clear that if my superiors or Congress decide to give contractors financial relief outside the terms of their contracts, that decision is a political matter and not my business. Nor is it my concern to make any contractor honest. My concern is to do what I can to insure that our contracts are administered fairly, equitably and efficiently so that the money appropriated for ships can be used

for building ships and not for paying unsubstantiated claims, and so that we can get as many ships as possible for the money appropriated. I believe that it is the responsibility of officials in the Naval Sea Systems Command as well as our superiors to insure that contractors live up to their contractual commitments.

l. I cautioned that it is possible that Newport News will attempt to make a deal on a giant overall settlement for their claims, tied in to the construction of the DLGN 41 and 42. This should not be permitted because the claims are a separate matter and must be substantiated legally and settled on their own merits.

m. I noted that there is always the temptation on the part of high level Government officials to afford ready access to high level contractor officials. I questioned whether those who so deal recognized that contractors use this as a means of playing on their vanity. They often create the illusion that only the high level officials on both sides are able to see the "big picture" and that they are the ones who should deal with each other on important matters. I understand that high level Government officials cannot deny contractor officials access to them, but I recommended that when contractual issues are raised the contractor officials should be referred to the proper contracting authorities. We must go back to a formal, official way of dealing with contractors on contractual issues.

n. I noted that Newport News has frequently raised the issue of lack of profits, yet they will not give the Navy the factual supporting information. They also convey the impression that they have been misled or bullied into accepting improper contracts; this is not so. I pointed out that it is ludicrous to think that the great brains of industry could be buffaloed by one lousy Admiral such as myself as they would have you believe. I noted that shipbuilders are asking for preferential treatment over other Government contractors because of inflation, even though Navy shipbuilding contracts are among the few Government contracts that have escalation provisions which give considerable protection to the shipbuilders. I noted that just like everybody else I am personally taking losses due to inflation. I pointed out that the stocks I own have greatly decreased in value, yet just like all other citizens I have no recourse to demand that my stock contract be rewritten to pay me more money. The average citizen, particularly working people, is being subjected to financial loss due to inflation. He does not have the ability to demand that the Government make up his loss. In this regard it is worth noting that since

Tenneco bought Newport News in 1968 Newport News has not yet reported a loss year despite the inflation, their officials continue to take home large salaries, and Tenneco is making the highest profits it has ever made.

o. Newport News would have the Navy believe that we need them more than they need our contracts. In this regard they have tried to use the threat of not submitting a bid for the SSN 688 Class as leverage to force the Navy to give them extra-contractual relief on the DLGN 41. The Navy should not succumb to this threat nor should the Navy be bluffed by the contractor's threat of litigation on the DLGN 41 contract. The Navy has a good case and should stick to it.

Mr. Leighton and I pointed out that insofar as the Navy has been able to determine, Newport News has not yet proceeded with ordering long lead material for the DLGN 42 even though they were authorized to do so since September 1974. Admiral Kidd asked whether Newport News' failure to proceed with ordering material for the DLGN 42 indicated that Newport News may be serious in their threat of stopping work on the DLGN 41. I expressed my opinion that if the Navy stands firm Newport News will not stop work on the DLGN 41 nor do I believe that they will actually go to court. However, I agreed with Admiral Kidd's recommendation that the Navy take all necessary legal steps now to be prepared to go to court in the Navy's behalf in the event Newport News does stop work. I certainly am not optimistic that the Navy and Newport News will be able to resolve their differences in the forthcoming DLGN 41 negotiations. Rather I am concerned that Newport News may look upon these negotiations as a means of laying the groundwork for future claims.

p. I stated that we must get outside counsel at once, just as the contractor does. I have been recommending this for three years without success. However, I believe the present circumstances make this a matter of urgency. Certainly it is clear that we may be faced with a court battle with Newport News, and we should do everything possible to improve our position. Full-time outside legal counsel is a must. I simply cannot comprehend why this matter continues to be held up.

3. I cannot overemphasize the importance of the Navy handling with complete formality and great care the Newport News challenge to the validity of the DLGN 41 option. If Newport

News were excused from this contract obligation, this could establish a dangerous precedent which could undermine contracts throughout the Department of Defense.

H. G. Rickover

Copy to:
Assistant Secretary of Defense
(Installations and Logistics)
Under Secretary of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts (NAVSEA)
Project Manager, Anti-Air Warfare Ship
Acquisition Project Office

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

5 MAY 1975

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Proposed revision to Navy claim procedures prescribed in Navy Procurement Directives (NPD 1-401.55)

Ref: (a) My Memorandum dtd 9 Aug 72 for the Chief of Naval Material, subj: Recommendations for improving Navy claims procedures based on experience gained from Litton Systems, Inc., Ingalls Nuclear Shipbuilding Division, claim against the Navy under contract N00024-68-C-0342 for construction of SSN's 680, 682, and 683
(b) My Memorandum dtd 22 Mar 73 for the Chief of Naval Material, subj: Recommendations for Improving Navy Claims Procedures

1. In August 1972, reference (a), I recommended specific action to improve Navy claims procedures. One recommendation was to require the senior company official in charge at the plant or location involved to certify, upon first submittal of a claim, that he had personally reviewed the claim and all supporting data, and that the information contained therein was current, complete, and accurate. The purpose of the certificate is to assure that all data bearing on the claim, whether or not favorable to the company's position, is disclosed and that the data is accurate, complete and current. This recommendation was ultimately incorporated in Navy Procurement Directive (NPD) 1-401.55.

2. I understand that your office is in the process of issuing a revision to NPD 1-401.55 which would redefine the term "claim" in a way which would eliminate the requirement for the certificate in all but a handful of cases. Such a redefinition might undercut other safeguards that have been established in the claims area.

3. Whether the contractors' requests for additional funds are labeled Claims, Requests for Equitable Adjustment, Engineering Change Proposals, Constructive Changes, Correction of Defects to Government Furnished Property, Suspensions, Requests for Relief under Public Law 85-804 or whatever, the need for effective safeguards is the same. As you know, the Electric Boat Division of General Dynamics Corporation recently submitted a $220 million

claim but labeled it a "Request for Equitable Adjustment." Under the proposed revision to NPD 1-401.55, this $220 million request might no longer qualify as a claim. Thus, the present NPD requirements for certification of the claim and for other safeguards might be voided.

4. I have been informed that further changes to the NPD now being considered at the staff level would take care of this problem. However, current plans are to issue the first change now, before the second change is approved for issue.

5. I recommend that NPD 1-401.55 not be issued until suitable provisions are made to ensure that the safeguards that have been established for handling claims, including the requirement for certification of claims, are applicable to all requests for increases in contract pricing by whatever name they may be called.

6. I would appreciate being informed of what action you take with regard to my recommendations.

H. G. Rickover

Copy to:
NAVSEA 00
NAVSEA 02
NAVSEA 00L

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
MAY 27 1975

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR POWER
NAVAL SEA SYSTEMS COMMAND

Subj: Senior Company Official's Certification Regarding Contract Claims and Changes

Ref: (a) Deputy Commander for Nuclear Power, NAVSEASYSCOM memo of 5 May 1975; Subj: Proposed revision to Navy claim procedures prescribed in Navy Procurement Directives (NPD 1-401.55)

Encl: (1) NPD 1-406.51

1. As stated in reference (a), Revision 4 to the Navy Procurement Directive (NPD) will modify and decrease the type and number of contractual actions that must be treated as formal contract claims. However, this revised NPD will not modify the requirement for complete documentation or justification required to support requests for equitable adjustment.

2. I concur with your comments regarding the need for a senior company official to certify to the completeness and accuracy of a request for equitable adjustment in cases involving complex fiscal or factual issues, particularly when extensive fact-finding is required to determine the extent of Government liability. Accordingly, the language set forth in enclosure (1), requiring a certificate in complex areas, will be incorporated into Revision 4 to the NPD.

F. H. MICHAELIS

Copy to:
NAVSEA 00
NAVSEA 02
NAVSEA 00L

Add a new paragraph 1-406.51 Negotiating complex change orders and requests for equitable adjustments pursuant to contract clauses.

(a) Policy. Circumstances may arise where a contractor's assertions, in which issues of contractual liability involving legal entitlement are presented, involve difficult or complex factual and fiscal issues requiring extensive factfinding and analysis of government liability. Examples include late or defective government furnished property or information, complex delay and disruption issues under formal change orders, formal suspensions of work or stop work orders, and other matters not defined as "claims" in the context of NPD 1-401.55(b). In such cases a multi-discipline approach involving procurement, technical/engineering, audit, and legal representatives is often necessary to protect the Government's interests and to assure a fair settlement of the Government's contractual responsibilities.

(b) PCO Responsibility. The procedure set forth in paragraph (a) may be used regardless of the estimated amount of the request for equitable adjustment; however, where the request for equitable adjustment exceeds $2,000,000, the ACO shall notify the PCO that a major modification to the contract in question may be required. The PCO shall make a decision based on the difficulty and complexity of the issues involved and the degree of factfinding and analysis that will be required to determine government liability, as to whether the negotiations will be conducted by the PCO under the provisions set forth in paragraph (a) above or will be conducted by ACO. While not required, the documentation outline set forth in NPD 1-401.55(d) is recommended as the format for these notifications of the PCO. If the PCO decides that he will negotiate and definitize these major requests for equitable adjustment, he shall employ the multi-discipline plan approach outlined in paragraph (a) above, including obtaining legal advice in the form of legal memoranda addressing the factors set forth in NPD 1-401.55(e)(3)(b).

(c) Affidavit. At the time a contractor initially submits a documented request for a major equitable adjustment as defined in paragraph (b), above, the cognizant contracting officer shall require an affidavit, as follows:

I, _____, the responsible senior company official authorized to commit the _____ with respect to its request for equitable adjustment dated _____, to contract(s) _____, being duly sworn, do hereby depose and say that: (i) the facts described in the request for equitable adjustment are current, complete and accurate; and (ii) the conclusions in the request for equitable adjustment accurately reflect the contractual actions for which the Navy is allegedly liable.

2. Add the following sentence to NPD 1-401.55(b) "Requests for equitable adjustments based on formal change orders, or other express contractual actions, involving complex legal or factual issues shall be handled in accordance with NPD 1-406.51."

3. Revise NPD 1-401.55(c)(2) to read:

". . . and equitably adjust such changes in the normal fashion - i.e., in accordance with ASPR 1-406(c)(ix), or when appropriate ~~NPD 1-406.51~~.

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

2 JUN 1975

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Proposed revision to Navy claim procedures prescribed in Navy Procurement Directives (NPD 1-401.55)

Ref: (a) My memo to you dtd 5 May 75, same subject
(b) Your memo to me dtd 27 May 75, subj: Senior company officials certification regarding contract claims and changes

1. In reference (a) I pointed out that your office was in the process of revising NPD 1-401.55 to redefine the term "claim" in a way which might undercut certain safeguards that have been established in the claims area. Specifically, the change would eliminate, in all but a handful of cases, the current requirement that the senior company official in charge at the plant location involved certify to the accuracy, currency, and completeness of his claim submissions. I recommended that the proposed revision to NPD 1-401.55 not be issued until suitable provisions are made to insure that the safeguards that have been established for handling claims, including the requirement for certification of claims, are applicable to all requests for increases in contract pricing by whatever name they may be called.

2. In reference (b) you pointed out that while the proposed revision to NPD 1-401.55 will modify and decrease the type and number of contractual actions that must be treated as formal contract claims, it will not modify the requirement for complete documentation or justification required to support requests for equitable adjustment. You also acknowledged "the need for a senior company official to certify to the completeness and accuracy of a request for equitable adjustment in cases involving complex fiscal or factual issues, particularly when extensive fact-finding is required to determine the extent of government liability." Attached to reference (b) was the additional language which you stated would be incorporated in Revision 4 to the NPD.

3. Upon review of the additional new language, and further reflection on the changes previously proposed for NPD 1-401.55 in Revision 4, I believe this change to NPD 1-401.55 should not be made. If implemented, it will weaken the Government's position in dealing with contractors and make the Navy look foolish before Congress for the following reasons:

a. The proposed changes will be interpreted as a public relations effort by the Navy to redefine itself out of the claims backlog. Revision 4 redefines the term "claim" so that claims based on alleged late or defective government-furnished material or information would be relabeled "requests for equitable adjustment." Some of the largest and most difficult claims we have fall into that category. The $30 million SSN 680, 682, 683 submarine claim submitted by Litton, for example, is based primarily on late government-furnished steel. The current $200 million claim from Electric Boat is based largely on late or defective government-furnished information. To contend that these are not claims would undermine the Navy's credibility.

b. At present, the NPD has extensive requirements for fact-finding, certificates, and other safeguards applicable to claims. Revision 4 to the NPD, even with the additional language proposed in your memorandum, would relax these requirements.

(1) The NPD currently requires contractor certification of all claims. The proposed new language reclassifies certain categories of claims as "requests for equitable adjustment." In such cases, the certification requirement is eliminated if the request is $2 million or less.

(2) The current NPD requirements for a thorough review of legal entitlement, extensive fact-finding, and analysis by the Government in the case of claims would not be mandatory in the case of "requests for equitable adjustments" in the amount of $2 million or less. Nor would these requirements be mandatory, even in the case of requests for equitable adjustment over $2 million, if the Procurement Contracting Officer at headquarters determines that the "request" can be handled in the field by the Administrative Contracting Officer.

4. The Navy has many large claims and more are probably forthcoming. In this environment, it is inappropriate for the Navy to be renaming its claims or relaxing its procedures for handling them. The fact that a contractor's claim involves government-furnished material or government-furnished information does not make it less of a claim. Moreover the safeguards to be applied in handling the claim should not depend on how it is labeled or whether the claim is handled by a Procurement Contracting Officer or an Administrative Contracting Officer.

5. I am unaware of any instance wherein the Government's interest has been compromised by calling a claim a claim. Nor after further review and reflection on the changes proposed to the NPD, do I see how relaxing the procedures presently applied to claims will benefit the Government. Accordingly, I recommend that the change to NPD 1-401.55 proposed in Revision 4 not be issued. I would appreciate being informed of what action you take in this regard.

H. G. Rickover

Copy to:
NAVSEA 00
NAVSEA 02
NAVSEA 00L

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
1 August 1975

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Proposed Revision to Navy Claim Procedures Prescribed in Navy Procurement Directives (NPD 1-401.55)

Ref : (a) My memo to you dtd 2 Jun 75; same subject
(b) Your memo to me, Ser No 132-75, dtd 24 Jul 75

1. In previous correspondence, including reference (a), I pointed out that your office was in the process of revising Navy Procurement Directive (NPD) 1-401.55 to redefine the term "claim" in a way which might undercut safeguards that had been established in the claims area. I recommended that the proposed revision not be issued until suitable provisions were made to insure that the established safeguards for handling claims, including the requirement for certification of claims, had been made applicable to all requests for increases in contract pricing by whatever name they may be called. In reference (a), I recommended that the proposed changes not be issued since they would be interpreted as a public relations effort on the part of the Navy to redefine itself out of the claims backlog.

2. In reference (b), you stated that you were withholding publication of the revision to NPD 1-401.55 to permit a thorough review. You further stated there have been several more iterations of this revision since my memorandum to you of 2 June 1975. However, you did not include a copy of the latest revision; consequently, I have had no opportunity to review it.

3. You stated in reference (b) that "all REA's greater than $500,000 will be given the same close scrutiny as claims, i.e., they must be certified by a 'senior company official'--no exception--and unless specifically excepted by the (Systems Command) Contracting Officer and Counsel, will be subjected to multi-discipline review and analysis..."

4. I noted in reference (a) that your proposed revision would delete the current NPD requirements for a thorough review of legal entitlement, extensive fact-finding, and analysis by the Government in the case of requests for equitable adjustment below a $2 million floor. Even above

$2 million, these protections would not be required if the Procurement Contracting Officer at Headquarters determined that the "request" could be handled in the field by the Administrative Contracting Officer. Your latest proposed revision lowers the floor to $500,000; this is an improvement. But it also provides that the Systems Command Contracting Officer and Counsel can except the "request" from the full review. Thus, the relaxation in the handling of claims or "requests" above the floor is still in the current version of the change. This is not in the best interest of the Government.

5. Since reference (b) did not mention dropping the previously proposed language which redefined "claims", I assume that this language is also in the currently proposed version. I reiterate that the proposed redefinition of "claims" will be interpreted as a public relations gimmick by the Navy to redefine itself out of the claims backlog. It will tend further to undermine the Navy's credibility with Congress and the public.

6. Expanding the requirement for submission of a certificate to include requests for equitable adjustment between $500,000 and $2 million is a step in the right direction. But I see no reason why the requirement for certification should be limited by the same $500,000 floor as the requirement for multi-discipline review. All taxpayers, including those with families, who earn $5,000 or even less per year are required to certify to the truth of their income tax returns regardless of amount; all Government employees must certify to the truth of the facts when submitting travel vouchers. I see no reason why Government contractors should not also be required to furnish accurate, complete, and current data even on claims or requests for equitable adjustment of less than $500,000 and to certify that fact. How do you think the citizens who have to pay these claims or requests for equitable adjustment with their tax dollars would vote on this issue? After all, are not you and I supposed to be representing their interests and desires?

7. It should be realized by all in the Navy who have the responsibility for paying and settling claims that the money must be paid out of ship construction appropriations. Therefore, every dollar spent by the Navy on an unverified claim or request for equitable adjustment reduces the funds available for ships. Those Navy officials who do not

understand this point might act differently if they treated public money as their own. Moreover, some officials responsible for handling and settling claims apparently consider it their duty to do what is expedient or to execute their own ideas of fairness to contractors regardless of the contractors' legal entitlement. I believe this attitude, more than any other factor, is responsible for the large number and amount of claims we are now experiencing.

8. In view of the above, I recommend the following:

   a. Make no changes to the present definition of "claims".

   b. Change NPD 1-401.55 to include all requests for equitable adjustment, as you have proposed to do.

   c. Require, without exception, the multi-discipline team approach for requests for equitable adjustment above a certain dollar limit, such as the $500,000 limit you propose. Provision should also be made for use of the multi-discipline team approach by the Systems Commands for complex cases under the dollar limit.

   d. Require submission of certification as set forth in NPD 1-401.55 for all requests for equitable adjustment regardless of dollar amount.

9. I would appreciate being informed of what action you take in regard to the above. I would also appreciate being furnished, for review, a copy of the revision to NPD 1-401.55 for comment prior to issuance.

H. G. Rickover

Copy to:
NAVSEA 00
NAVSEA 02
NAVSEA 00L

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

AUG 11 1975

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR POWER,
NAVAL SEA SYSTEMS COMMAND

Subj: Proposed revision to Navy Procurement Directive
(NPD 1-401.55 July '75)

Ref: (a) Your memorandum of 1 August 1975

1. Subsequent to my last memorandum of 24 July on the subject, I have reviewed reference (a) and have had a useful exchange of views on this matter with members of your staff. I have also considered the views of other Systems Commands. I have concluded that any major revision to NPD 1-401.55 requires further study to assure that Navy policy on this matter not only provides adequate procedures for proper resolution of claims, but also fully addresses the significant area of negotiating complex claims for equitable adjustments pursuant to contract clauses.

2. Accordingly, in the interim, I am preparing to issue NPD Revision 4 as attached, within the next ten days. This directive not only will retain the previous definition of claims, but provides for stronger controls over claims for equitable adjustments, an item of strong interest to me.

3. I value your thoughts on this matter.

E. H. MICHAELIS

1–401.55 Contractor Claims; Policies and Procedures.

(a) *General.* The effective development and production of major weapons systems within the policies established by DOD Directive 5000.1 of 13 July 1971 require the teamwork and singleness of purpose that characterizes successful acquisitions. Delay in resolution of contractor claims can produce a serious impact upon the business relationship between the Navy and certain of its major contractors. The following policies and (as applicable) procedures shall apply to major weapon systems procurements and also to contracts for other than major weapon systems.

(b) *Definition.* The term "claim" for the purposes of this paragraph 1–401.55 and NPD 1–403.51(b)(2)a(iii) and (b)(2)b(iv) means a request for adjustment of a single contract involving to a significant extent a "constructive change" –i.e., a change based on Government conduct, including actions or inactions, which is not a formal written change order but which has the effect of requiring the contractor to perform work different from or in addition to that prescribed by the original terms of the contract–or late or defective Government-furnished property or information. "Claim" does not mean a request for equitable adjustment solely for formal written change orders or price adjustments pursuant to escalation or price redetermination, provisions of Public Law 85-804, or other contract assertions or adjustments not enumerated in the preceding sentence. When claims under two or more contracts arise from the same or essentially similar operative facts and are based on the same theory of recovery, such claims shall be treated as a "claim" within the definition provided above.

(c) *Policies Regarding Submission, Entertainment and Documentation of Claims.*

(1) *Prompt, Fair and Open Dealings with Claimants.*

Acquisition programs must be conducted in a manner calculated to minimize the occurrence of claims. Further, those claims which arise despite appropriate precautions must be resolved as promptly as prudence permits by those most directly involved. The causes of claims must be minimized through realistic planning and contracting,

careful attention to the action required to meet the Navy's obligations and tight control over the changes process. Occurrences which may lead to claims must be recognized as they happen and appropriate action initiated promptly. Elements of Naval activities at all levels are expected to face claim situations squarely, report them to the appropriate levels of management, take prompt action to get the facts, make an objective analysis, and seek prompt resolution. Dealings will be fair and open with the expectation of equal consideration from contractors.

(2) *Formal and Constructive Changes.*

a. In those cases where Navy actions (or inactions) alleged by the contractor, after appropriate evaluation, constitute a change, the Contracting Officer should promptly formalize such constructive change(s) in writing, irrespective of whether the contract contains the "Notification of Changes" clause, ASPR 7-104.86. Negotiation and settlement of such changes should be handled in accordance with ASPR 1—406(c)(ix), or when appropriate NPD 1—406.51.

The procedures outlined in subparagraph c. below are for use on an exception basis where the contractor has not presented a full disclosure of pertinent facts or a timely determination of Navy responsibility is not feasible.

b. With respect to those formal written changes as to which the contractor alleges a factual or other inter-relationship with a claim, activities should exert every effort to equitably adjust such changes coupled with allowance for any disruption or delay impact determined to be appropriate by the procuring activity.

c. In exceptional cases where disruption, delay or other claimed impacts are known to exist and cannot be currently resolved, the procuring activity may proceed with equitable adjustments covering the inter-related formal changes coupled with usage of qualified release. The qualified release should specifically identify the inter-relationship with the contractor's claim such as delay or disruption impacts reserving to the contractor the right to pursue and demonstrate support for a separate equitable adjustment therefor under the contract.

(3) *Rejection of "Total Cost" and "Total Time" based Claims*

a. Contractors have occasionally submitted claims based on "total cost" or "total time" approaches, i.e., they have asserted that the government was wholly responsible for all costs incurred in excess of the contract price, or for all delay, without proof that such excess costs or delays were caused by government conduct — not by contractor conduct or by concurrent causes. Yet in changes claims there is a well-established requirement to demonstrate causality between the change and resulting quantum. This derives from the terms of the Changes clause itself: ". . .if any such change causes an increase or decrease in the cost of, or the time . . . for, performance of any part of the work. . ." The total cost approach is suspect because it assumes that the contractor's initial contract price was reasonable; that the government alone caused his increased costs; and that the contractor's performance costs were reasonable. Only in few rare cases has the total cost approach been accepted, and then only as a "last resort" — when the contracting officer did not make the sort of equitable adjustment required by the Changes clause and the circumstances allowed the contracting officer, board, or court to *accept* the three foregoing assumptions.

b. A claimant filing a total cost or total time based claim has the burden of establishing that there is no other feasible, acceptable basis for computing his increased costs or delays. He must prove that there is no way of correlating government actions and omissions to historical cost elements or even to reasonably substantiated cost estimates. If the contractor fails to sustain this burden, then as a policy matter the Navy should reject any contractor claim premised on a "total cost" or "total time" approach.

(4) *Criteria for Submitting, Documenting and Entertaining Claims.*

a. Some contractors have submitted claims, portions of which, upon review, are found to be exaggerated, inflated, or unsupportable. Claims sometimes fail to differentiate between factual and judgmental assertions and to support all assertions with specifically identified evidence. Such submission can delay and frustrate the Navy's claim review, analysis and evaluation. Accordingly, it is necessary to take steps to promote more readily reviewable claim submissions by establishing requirements for the evidentiary documentation of claims and by requiring responsible contractor officials to endorse the claims submitted.

b. The general criteria for information required to support claim settlement include the existence of a legal basis for entitlement, facts meeting the elements of proof required to support the basis of entitlement, and adequate factual support for the amounts claimed. The Navy should require a proper claim submission on the basis provided in the changes clause, namely, a basis factually demonstrating documented scopes of work correlated to provable instances or categories of government liability. The Navy should, in all cases, require demonstration of causal support and documentation of quantum, in as much specificity as the facts will permit.

c. Claimants should be advised that all claim assertions must be supported by specifically identified evidence (including applicable historical and planned cost and production data from the contractor's books and records), and that opinions, conclusions or judgmental assertions not supported by such evidence, or by a sound and reasonable rationale, which is fully discussed, are without probative value and unacceptable.

d. An individual DD Form 633—5 shall be submitted for each element of a contractor's claim at the time of the initial claim submission, for any material revision of the claim, and prior to the execution of a settlement agreement on the claim.

e. The Navy should require, at the time of initial submission of a claim an affidavit, as follows:

I, _____*_____, the responsible senior company official authorized to commit the _____**_____ with respect to its claim dated _____, under contract(s) _____, being duly sworn, do hereby depose and say that, to the best of my knowledge and belief: (i) the facts described in the claim are current, complete and accurate; and (ii) the conclusions in the claim accurately reflect the material damages or contract adjustments for which the Navy is allegedly liable.

_____
(Signature)

* Name and title of company official signing affidavit. In a large company, signature by the head of a plant or division is acceptable, if such individual is authorized to commit the corporate entity which is a party to the contract under which the claim is asserted.

** Name of corporate or other business entity submitting claim.

Unless otherwise authorized in writing by NAVMAT, claim evaluations should not commence until an appropriate affidavit has been received.

(4) Determine whether the contractor's direct and indirect costs are reasonable, allocable and otherwise allowable, that costs represent what performance of the contractor should cost, assuming reasonable economy and efficiency; take appropriate corrective action when necessary.

(c) *Additional Functions.* The functions listed below are in addition to those listed in ASPR 1—406(c) and shall be performed when requested by the procuring contracting office, project manager or procuring activity.

(1) Conduct pre-solicitation review and evaluation of the Schedule, General Provisions, Specifications and other provisions of proposed contracts to determine the adequacy of contractual requirements for contract administration purposes.

(2) Participate in negotiations and in source selections.

(3) Issue orders under contracts for provisioned and other items, and orders under basic ordering agreements.

(4) Participate in cost and other studies conducted by higher authority.

1-406.51 Negotiating Complex Requests or Claims for Equitable Adjustments Pursuant to Contract Clauses.

Circumstances may arise where a contractor's assertions involve difficult or complex legal, factual and fiscal issues requiring extensive fact-finding and analysis of government liability. Examples include complex delay and disruption issues under formal change orders, and formal suspensions of work or stop work orders. In such circumstances, the request or claim for equitable adjustment shall be subject to the requirements of NPD 1-401.55 applicable to claims.

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

6 August 1975

Mr. N. W. Freeman
Chairman of the Board and Chief
Policy Officer
Tenneco Incorporated
Tenneco Building
P. O. Box 2511
Houston, Texas 77001

Dear Mr. Freeman:

This is in response to your letter of April 17, 1975, which forwarded Mr. Diesel's comments on my testimony before the Seapower Subcommittee of the House Armed Services Committee on September 23, 1974. I understand that Mr. Diesel's comments have also been forwarded to the Secretary of the Navy, the Deputy Secretary of Defense, the Secretary of Defense and perhaps to others.

Your letter states:

> "...your testimony on this occasion goes far beyond fair and constructive criticism. By repeatedly singling out Newport News and using descriptions of incidents and examples which do not convey all the facts (or which convey them in a misleading fashion) you have, it seems, set out to tarnish the record of Newport News Shipbuilding. A disservice, in my opinion, has been done to thousands of fine employees who have contributed greatly to the Navy's nuclear shipbuilding program over the past two decades..."

In the same vein, Mr. Diesel's introductory comments appended to your letter state that much of my testimony was "inaccurate or seriously misleading and therefore unfair," and that I have done "a disservice to the reputation of our Company and particularly to the dedicated workers who with their fathers and grandfathers have constructed many of the Navy's finest ships for nearly a century."

The fact of the matter is that my testimony of September 23, 1974, to the Seapower Subcommittee was given in response to allegations made earlier in the hearings by witnesses from the shipbuilding industry. The September 9, 1974, issue of U. S. News and World Report in an article titled Civilian Shipbuilders "Mutiny" Against Navy, summarized the shipbuilders' testimony including that of Mr. Diesel by saying:

> "In testimony before Congress, American shipbuilders have signaled that they are in what amounts to a state of revolt against the U.S. Navy."

I did not single out Newport News for criticism; my comments concerning Newport News were an answer to specific charges against the Navy made by Mr. Diesel in his testimony of August 6, 1974.

I testified concerning loafing and the need for improved productivity and workmanship at all our shipyards, public and private. I did not single out productivity or workmanship at Newport News as being worse than at other places. The thrust of my comments was that increased costs which result from poor productivity or poor workmanship are a shipyard responsibility--not the Navy's.

Mr. Diesel himself has recognized the need to improve productivity. A recent news article which appeared in the Newport News - Hampton, Virginia, Daily Press stated that Mr. Diesel made a "strong, blunt speech" to Apprentice School alumni gathered for an annual banquet. The article says that "he told those holding jobs at the shipyard to, in effect, 'shape up or ship out.'" The article goes on to state:

> "The long talk was delivered forcefully by Diesel and at some points he used expletives to get his message across. The theme of declining American worker productivity is one he has turned to with increasing frequency in his speeches.
>
> "He told of a recent visit to some unnamed area of the yard several days ago 20 minutes after the workday had started.
>
> "'I want to tell you that I was lucky to find 20 percent working, even if I gave everyone the benefit of the doubt' Diesel related.
>
> "Despite his recent announcement of yard layoffs and financial troubles, 'I still don't think people are listening to me,' he said. 'I've got a lot of heat on me right now because we have to be more efficient. Everyone agrees and says yes but the inefficiency never occurs in their bailiwick.'"

I agree with the comments attributed to Mr. Diesel in the news article, and I am glad to see that he is taking steps to get this message across to the people in his shipyard. I doubt that you would characterize Mr. Diesel's criticism of the productivity at Newport News as an effort "to tarnish the record of Newport News Shipbuilding" or accuse him of doing "a disservice" to the "thousands of fine employees who have contributed greatly to the Navy's shipbuilding program over the last two decades." Likewise, my comments about the need for improved productivity and workmanship at shipyards should not be so characterized.

The capability of Newport News to design, build and repair ships was not questioned in my testimony. Newport News has a proven record of building good ships. If I did not believe that, I would not have put so much effort over the past two decades into assisting the yard to develop its capability in all phases of nuclear submarine and surface warship design, construction, and repair. As Mr. Diesel himself notes, I have frequently congratulated Newport News on the quality of the ships they deliver.

The issue I addressed in my testimony was that it is incorrect and improper for the company to attribute essentially all its financial problems to the Navy, and I cited facts supporting this view.

When Tenneco bought Newport News in 1968, it acquired an experienced shipyard with unique capabilities. It was then and still is, the only shipyard building nuclear powered surface warships or aircraft carriers. The Navy has a considerable stake in the shipyard's capabilities, since, to a large extent, these were developed and paid for under Navy contracts.

Doing business with Newport News under Tenneco management was not much different at first than it had been previously. For the most part, Navy ships were constructed by the same people following the same procedures that had been in effect for years. Generally, the Navy was able to work out its differences with the company amicably based on the merits of the individual issues. However, as time passed, the traditional relationship changed.

In 1971 and 1972, Newport News projected a manpower buildup from a low of 18,200 early in 1971 to over 30,000 employees in 1973. The company considered this buildup to be necessary to meet its commitments on existing Navy contracts. Company officials also stated they could increase the work force to a level of over 30,000 if necessary. However, at that time, 1972, the company forecast a decline in the total Navy work after mid-1974. In the fall of 1972, Newport News announced plans to build a new yard for merchant ship construction adjacent to the existing yard, and announced the signing of a contract for three Liquified Natural Gas Carriers (LNG's) to be constructed in the new commercial yard. At that time, Newport News had an employment level of about 27,000 people and was still building up its manpower.

I was concerned over the potential impact of the commercial work on Navy work and entered into discussions with you and Mr. L. C. Ackerman, then Chairman of the Board and Chief Executive Officer of Newport News. You both told me that Tenneco wanted to get into commercial ship construction; that the company had chosen the Newport News site to provide continuing work for the work force, which was to be further expanded to meet commitments on existing Navy contracts. Newport News considered the expanded work force would not be fully needed for Navy work after mid-1974. At that time I told you that in my opinion Tenneco had made an unfortunate choice in placing the commercial yard at Newport News, because the Tidewater area already had large Government and industrial commitments for its labor

market. Also, at meetings with you and Mr. Ackerman, I expressed my concern that Newport News was underestimating the difficulty of meeting their commitments on Navy work and overestimating their ability to build up the manpower necessary to handle both the projected Navy and commercial work. You and Mr. Ackerman stated that the manpower required to construct the LNG's and successive commercial ships could be accommodated by the decline in required manpower forecast by Newport News for Navy work.

These discussions culminated in your Tenneco policy letter to me of February 12, 1973, which assured me that:

> "Tenneco will not allow performance of work on non-Navy contracts to interfere with the performance of work necessary to meet Newport News commitments on Navy contracts."

It is of great importance to the Navy that Tenneco and Newport News live up to this policy commitment.

By the time the Newport News manpower buildup reached a level of about 28,000 employees in early 1973, apparently the company found that the dilution of the skill level of their overall work force, together with the declining ability of the people they were able to hire, caused a large reduction in productivity and a large increase in the number of fabrication errors, as well as a high employee turnover rate. In 1972 and 1973, Newport News hired more than 18,000 people. But during this same period about 17,000 employees left the company. This resulted in a net increase of a little over 1000 in the total employment level over the two-year period. In 1973 you and Mr. Ackerman announced that Newport News had abandoned its plans to build up to 30,000 employees. Since that time the employment level has decreased to the present level of about 22,000--close to the level in 1968 when Tenneco bought the shipyard.

The decline in productivity during the work force expansion and the increase in rework necessary to correct the increased number of mistakes made during construction caused the number of man-hours required to complete present Navy contracts to be greater than Newport News had expected when the contracts were signed. Faced with the inability to obtain the labor force level of 30,000 employees necessary to meet their existing contracts on Navy ships, declining productivity, increased construction deficiencies requiring correction, and other problems, Newport News stretched out Navy ship construction schedules.

These manpower problems, which under the contract terms are the responsibility of the shipyard, increased costs. However, the cost problems were compounded by Newport News management inability to control overhead costs adequately. Much of the overhead cost increase was beyond the control of management; such as the increased costs of fuel oil, changes in social legislation, and general inflation. However, many overhead costs were susceptible to management control. Following the Tenneco acquisition of Newport News in 1968, indirect labor costs as a percentage of direct

labor costs increased substantially through 1973. In 1974, Newport News management substantially reduced indirect labor costs. A Supervisor of Shipbuilding study shows that had such action been initiated at the outset, approximately $37 million could have been avoided.

Today, since the yard's trained manpower is still not at a high enough level to meet existing commitments on Navy contracts and commercial contracts, Newport News still faces a choice among three costly alternatives:

(1) Attempt again to achieve a significant increase in manpower.

(2) Slip schedules on commercial ships.

(3) Slip schedules on Navy ships further.

Much of the recent acrimony has resulted from Newport News actions to resolve this dilemma by further slipping Navy ship schedules, while claiming that the Navy is responsible for the delays and higher costs which accrue. This is at the heart of the dispute over the options for construction of the DLGN 41 and DLGN 42 wherein Newport News proposed to delay the ships 19 and 23 months respectively beyond the contract delivery dates proposed by Newport News in November 1973 and accepted by the Navy, and insisted that the Navy pay the increased costs of the delays.

Because Newport News is not making as much profit on Navy new construction work as had been expected and is in a loss situation on some contracts, the company has established a group of about 40 people to study ways to blame the Navy for increases and to prepare claims. This group is augmented with people from various shipyard departments, with the total sometimes exceeding 100 people working on claims. Throughout the shipyard, employees search out and report actions and events that might be used as a basis for a claim against the Navy. Even minor technical details or problems never previously so handled are now treated as contractual matters. Important work is delayed and attention diverted from primary responsibilities as technical people, both Navy and shipyard employees, become embroiled in contractual disputes.

Settlement of contract changes has become ificreasingly difficult. Often the company either refuses to price the changes in advance, quotes an excessive and unsupported price, or demands the right to reopen contract pricing later for other reasons such as the "cumulative impact of contract changes."

A matter of even greater concern is the danger that the strong management emphasis on finding ways to blame the Government for increased costs will detract from waterfront and engineering management attention to completing work in accordance with specifications and shipyard schedules, thus increasing costs further. It is easy to develop an attitude throughout

the shipyard that failure to perform is somehow excusable and is the responsibility of the Government, since this appears to be consonant with the publicly expressed attitude of top management.

Company representatives have lobbied extensively in Congress and the Executive Branch urging that existing contracts be altered to pay all costs, plus a profit; asking that future contracts guarantee profit levels; complaining that the Government treated Newport News unfairly; complaining that Government procurement policies are poor; threatening to withdraw from Navy work--in short, trying to pass to the Navy total responsibility for financial problems at Newport News regardless of the company's responsibilities under its Navy contracts. Also, Mr. Diesel mounted a public attack on the Navy in press releases at Newport News and in testimony before the Seapower Subcommittee of the House Armed Services Committee.

My testimony to the Seapower Subcommittee insofar as it related to Newport News was a response to some of Mr. Diesel's charges. For example:

a. Mr. Diesel complained of "the stultifying Government bureaucracy under which we had been forced to labor"; alleged that "unrealistic target prices are responsible in large part for the dire situation now facing the Navy's shipbuilding program"; and stated: "The Navy's 10-year pattern of coaxing, cajoling, bullying and arm-twisting shipbuilders and suppliers to take marginal, high-risk and frequently unprofitable business--all with promises of future rainbows if they acquiesce and economic disaster if they refuse--is just about over."

I testified that the fixed price incentive fee Navy construction contracts on which Newport News was predicting losses were either competitively awarded without price negotiations, or were sole source contracts wherein Newport News fully expected to make an adequate profit within the negotiated price of the contract at the time the company accepted the contract. Under the circumstances, subsequent financial problems the company may have experienced on these contracts can hardly be blamed on Navy "coaxing," "cajoling," "bullying," or "arm-twisting."

b. Mr. Diesel complained about the large number of contract changes and said that these were a major source of cost overruns. I pointed out that Government initiated changes were negligible on the contracts, which represented almost two-thirds of the Newport News projected losses according to the financial reports and billings Newport News submitted to the Navy.

c. Mr. Diesel complained about the impact of inflation on shipbuilding. I pointed out that because of special escalation clauses used in shipbuilding contracts, shipbuilders are better protected against inflation than most other defense contractors.

d. Mr. Diesel advocated cost-plus type contracts for new construction. I pointed out that whenever the Government is committed to reimburse all

costs, and the amount of profit is based on the amount of cost, there is no incentive to hold costs down.

e. Mr. Diesel stated that the NIMITZ was originally scheduled for delivery between June 1972 and September 1973. He complained that delays in the NIMITZ design and Government-furnished equipment were directly responsible for a large portion of the 4500 man reduction in force at Newport News from July 1968 until February 1971. I pointed out that half of the 1968-1970 layoff occurred before delay in the NIMITZ delivery beyond mid-1972 was identified; that the manning on commercial work decreased about the same amount as the overall yard manning reduction during this period; that the reduction had no relation with those delays on the NIMITZ which had not yet taken place; and that it would have been impossible for the NIMITZ to have absorbed most of the 4500 men Newport News laid off in addition to the 3000 man average manning assigned to the NIMITZ in 1970. I said that I recognized that Mr. Diesel was dependent on his staff for his information, since he did not arrive at Newport News until about May 1972 and had no prior shipbuilding experience.

f. Mr. Diesel alleged that "the Navy has on several occasions attempted to thwart Newport News...in our efforts to secure commercial shipbuilding contracts." I pointed out that the Navy had merely sought assurances that performance of work on non-Navy contracts would not be allowed to interfere with the performance of work necessary to meet Newport News commitments on Navy contracts.

g. Mr. Diesel referred to the "withholding of steel priority allocations" for three Ultra Large Crude carriers contracted by Newport News as an "unwarranted interference" by the Navy. I pointed out that the Navy and the Office of the Secretary of Defense recommended and the Office of Preparedness of the General Services Administration decided that very large tankers do not meet the requirements necessary to qualify for defense priorities under the Defense Production Act.

h. Mr. Diesel and other shipyard executives complained of low profits. I pointed out that contractors have great flexibility in how they can calculate annual profits; that because contractors do not generally make their profit calculations available for Government review the Navy cannot verify the validity of the annual profit figures the shipbuilders report.

i. Mr. Diesel said that "substantially increased manpower levels would not cure, and would not have prevented, current delays." He said that "the manpower question threatens to become a 'red herring'" and expressed concern "lest manpower become a facile shibboleth and an all too convenient explanation of shipyard delays." I noted examples where Navy ships were being delayed primarily due to lack of adequate skilled manpower.

j. Mr. Diesel complained about there being too many Government inspectors checking on Newport News work. I pointed out the importance of insuring that the ships are built and overhauled in conformance with

Government specifications. In many cases the Government representatives help the yard by identifying problem areas and expediting resolution of technical problems. I also pointed out that the shipbuilder generally guarantees the ship for only six months after its delivery, while the Navy bears responsibility throughout the remainder of ship life, sometimes 30 years or more.

k. Mr. Diesel complained about the 2200 men in the yard assigned to ships crews. He said that "while the necessity for the presence of some of these people is indisputable, others are unnecessary and their presence is counter-productive. In fact, many of these people are in our yard simply for training purposes." I noted that the Navy's contracts signed by Newport News specifically provide for the crews to be assigned to the ships while in the yard. I also noted that Mr. Diesel had not yet found the time to accompany me on an initial sea trial of any one of the ships built at Newport News. In this way he could have observed for himself what is required of the Navy crew and why it is important for them, about half of whom have never had prior sea experience, to participate in the surveillance of the installation, and performance of the propulsion systems in these complex warships.

l. Mr. Diesel complained that Government surveillance of the company's purchasing operation is excessive. I pointed out that the Government has a direct financial stake in the reasonableness of costs of subcontracted material, which averages about 40 percent of the shipbuilding contract cost of a warship. I cited specific examples indicating the need for Government surveillance to insure that shipyard procured material is purchased in the most economical way possible.

m. Mr. Diesel testified that "one of the most unconscionable developments in Navy shipbuilding contracting has been the proliferation of so-called 'anti-claims' and 'contractor-risk' clauses. These clauses... were a direct outgrowth of the Navy's attempt to shift responsibility for its deficient and/or outdated contracting and contract administration practices to the shipbuilder." I pointed out that after extensive review by the Armed Services Procurement Regulation Committee and by industry, the Navy developed clauses in an attempt to preclude large, after-the-fact claims based on constructive changes. These clauses do not forbid claims. They require a company to report promptly any situation which it believes constitutes a constructive change, rather than waiting until the contract has been completed and then claiming the Government owes money for some action committed years before.

n. Mr. Diesel complained that the Navy would not accept the Newport News estimate for the NIMITZ "because it resulted in too high a target cost" and that actual experience has borne out the validity of the company's original estimate. He said that: "There was no serious effort by the Navy to demonstrate that our estimate was erroneous or unrealistically high--just that the resultant cost was regarded as unpalatable to Congress." Mr. Leighton of my staff pointed out that the Navy spent more effort and went into more detail on the cost estimate of the NIMITZ than on any other

ship in the Navy's history; that the Navy's estimate which was based on review of the Newport News proposal as well as Newport News' experience in construction of previous aircraft carriers, was substantially below the Newport News estimate; and that as a result of the negotiations a target price and the sharing agreement was finally agreed to by both the Navy and the company.

o. Mr. Diesel complained that the Norfolk Naval Shipyard was advertising job openings by radio which reached the Newport News work force. I pointed out Newport News' efforts to hire skilled workers included individual letters with job application blanks sent to a number of Norfolk Naval Shipyard emoloyees.

In summary, my testimony concerning Newport News was not a criticism of Newport News workers or their forebears. It was my response to Mr. Diesel's attack on the Navy in which I attempted to inform the Seapower Subcommittee of some pertinent facts that Mr. Diesel omitted, facts which I believe are essential to understanding the shipyard situation.

Your letter enclosed a 64 page document prepared by Mr. Diesel which gives his response to some of my testimony. Mr. Diesel says that in this statement he had "made an effort to 'set the record straight,' to present relevant information which is factually correct, and technically accurate concerning some of Admiral Rickover's statements." He says that his purpose "has been to demonstrate the exaggerated, incomplete and at times inaccurate and misleading nature" of my commentary as it relates to Newport News. In your letter you state that Mr. Diesel's statement presents "a balanced appraisal of the facts relative to some of the allegations and events" I addressed in my testimony and that you trust that after reviewing it I "will have a more complete understanding of a number of episodes and incidents" which I addressed in my testimony.

I have read Mr. Diesel's statement most carefully. It is misleading and many of the charges are inaccurate. It is apparent that Mr. Diesel's statement was carefully prepared to reinforce his attempts to attribute Newport News' financial problems to the Navy far beyond the Navy's contractual responsibilities. Moreover, I am disturbed by Mr. Diesel's mis-information and lack of understanding concerning the technical issues discussed in my testimony and in his response. My comments on the points he raised in the order in which he raised them are summarized as follows:

I. SHIPBUILDERS PROFITS AND LOSSES

A. Guaranteed Profits. When I testified that one shipbuilder, whom I did not identify, had suggested that the Navy guarantee a 7 percent profit on costs for his Navy work, I was referring to the position you took in a meeting on January 31, 1974, with the Deputy Secretary of Defense--not solely to Mr. Diesel's testimony as he apparently assumes. In that

meeting, which Mr. Diesel and your Washington representative, Mr. Thomas Corcoran also attended, you indicated that the company, in the future, would require a form of contract which would guarantee 7 percent profit after interest and other unallowable costs. The company's position in this regard was confirmed by Mr. Corcoran in a subsequent meeting with the Secretary of the Navy on February 13, 1974, in which he said that the Deputy Secretary of Defense expected the Navy to develop within 30 days a form of contract for future Navy work which would guarantee 7 percent profit after unallowables and interest. Navy records indicate no such commitment. Further, Navy and Defense Department counsel advised that a cost plus percentage of cost contract would be illegal. I note that the Seapower Subcommittee in the report in its hearings on Current Status of Shipyards, 1974, dated December 31, 1974, expressed a similar view:

"The Problem of Profits

"It is axiomatic that the private business sector must operate on profits in order to survive. The shipbuilding portion of that sector is no exception. However, profits are made out of many actions. Many of the above factors leading to lack of profits are already under consideration by the Navy and the Department of Defense in an effort to provide a proper atmosphere for the shipbuilding industry. The Navy/Marine Acquisitions Review Council, just instituted by the Secretary of the Navy, also considered such matters.

"However, there is another factor which leads to profits which cannot be legislated, and that factor is sound management. Under the free enterprise system companies rise or fall on sound management. The Subcommittee has noticed that it takes special talents in the shipbuilding industry. Certainly no action should be expected which will guarantee profits to any shipbuilder regardless of whether or not he does his job well. One shipbuilder strongly suggested that the Congress provide cost plus seven percent of cost for all shipbuilding contracts. The Subcommittee rejects that proposal. Cost plus percentage of cost contracts for the Federal Government are banned by law. (Title 41, United States Code, Sec. 254(b).) There are also specific bans on cost plus percentage of cost contracts for defense contractors. (Title 10, United States Code, Sec. 2906(a); Title 50, United States Code, Sec. 1432.) There were good reasons for these statutes.

"Hearings between the two World Wars brought out the clear disadvantages of cost plus contracts--including the lack of control of the price and the mischarging of expenses to a contract. (One such investigation resulted in 20 large volumes of hearings and Senate Report No. 944, 74th Cong., 1st. Session, on the Investigation on the Munitions Industry and the Naval Shipbuilding. The report is dated May 13, 1935.)

"If there were going to be--as indeed is probably inevitable--a mixture of firm fixed price merchant marine construction and naval construction in the same yard, then it is doubly important to be sure that the naval construction will not bear an undue portion of the yard expenses. The suggestion of possible fraud by two large contractors (See Appendix D) emphasizes the need for keeping contractors costs under careful scrutiny.

"In establishing the first incentive type contract for the Navy, Secretary Forrestal said: 'Without a firm closed contract price the incentive contract would be open to abuse.' (Forrestal and the Navy, Albion and Connery, 1962, p. 112).

"The Subcommittee does not believe the Navy should enter into any open-ended cost type shipbuilding contracts of any nature. Such contracts would, of course, end the criticism of cost overruns over the contract price but the amounts paid by the taxpayer would undoubtedly be much greater."

I note that in his testimony to the Seapower Subcommittee Mr. Diesel stated:

"First, new Navy shipbuilding contracts will be undertaken only at a level and on a basis which gives assurance of a modest profit--in the area of 7 percent of our total program cost." (p. 915)

* * * * *

"Consistent with our profit proposal to representatives of the Navy and DOD of 7 percent of total cost--before taxes but after interest and disallowances--which I cited earlier, we would be willing to accept such a limitation and guarantee the return to the Navy of any final contract price settlement amount in excess of this percentage if such were disclosed by subsequent audit." (p. 935)

B. Escalation. Despite what Mr. Diesel says it is a fact that while the United States as a whole has suffered in recent years from unanticipated inflation, shipbuilders, by virtue of the escalation clauses included in Navy contracts, have been better protected than have other defense contractors without such clauses. As I testified, to the extent any shipbuilder is behind his contract schedule or overrunning his contract price, he will not recover his actual escalation. These are, of course, major factors causing Newport News to project losses under the terms of the options for the DLGN 41 and DLGN 42, since, as I noted earlier, Newport News proposes to delay delivery of the ships 19 and 23 months respectively beyond the contract delivery dates. Although I did not mention Newport News in my testimony concerning escalation, my testimony would have been more complete if I had pointed out that some Newport News contracts, which were awarded on a negotiated sole-source basis, give Newport News even

better protection against inflation than contracts placed with other shipbuilders during the same period.

C. Progress Payments. Mr. Diesel's discussion of the Navy's contract provisions for progress payments is a non sequitur. The fact cited by Mr. Diesel that Newport News, on ships other than the NIMITZ and EISENHOWER, had collected, at the end of 1974, less than 88 percent of incurred costs, is due in large part to Newport News failing to achieve a percentage of work progress commensurate with the amount of contract funds expended. It was not due to progress payments on shipbuilding contracts being limited to less than 100 percent of costs, as is the case in most segments of the defense industry. Contrary to the statements made by Mr. Diesel, my testimony that progress payment provisions on shipbuilding contracts are more favorable than provided other segments of defense industry is factual. It is also consistent with the findings of a study made by the Assistant Secretary of the Navy (Financial Management).

D. Accounting and Financial Reporting Practices. In my testimony I pointed out that under the so-called percentage of completion method of accounting for profits and losses on long-term contracts, contractors have the accounting flexibility to convert sizable losses into respectable profits or vice-versa on an annual basis, simply by changing management estimates of progress and contract revenues. Without identifying any particular contractor, I cited several specific examples of what I was referring to. Mr. Diesel recognized that two of these examples were based on financial data reported by Newport News and devoted five pages to support his contention that "Government actions which have increased costs without compensating price adjustments" are "the primary cause" that Newport News contracts "which at commencement appeared at least marginally profitable are now in a loss, or near loss, position." Mr. Diesel concluded:

> "Admiral Rickover is, of course, entitled to his opinions on cost accounting and financial reporting even though we, and many in the accounting and financial professions, do not agree with him. However, when he implies that the methods used by Newport News Shipbuilding--although accepted and approved by the accounting profession and Government agencies--are somehow shoddy and manipulative, I think he exceeds the bounds of fair criticism. Unlike systems on board a ship, accounting systems are not improper or inappropriate simply because they do not bring about a particular desired result."

I did not mention Newport News or Tenneco in my statements, nor did I use the term "shoddy." I merely cited factual examples based on experience with several contractors, two of which were based on Newport News financial reports. My object was to illustrate why Members of Congress and defense officials should not place credence in unverified financial data provided by shipbuilders or other contractors.

Contrary to Mr. Diesel's contentions, independent public accountants cannot verify estimates provided by shipbuilders, because they are not qualified to assess the status of completion of complex warships; nor can they evaluate the merits of unadjudicated shipbuilder's claims. In consequence, contractors have ample flexibility under this arrangement to arrive at widely varying annual profit or loss figures. Contractors who cite annual profit figures on Navy work in their efforts to influence policy decisions should be required to make their books and records available so the Navy can assess the validity of these figures. Newport News and other shipbuilders have refused to make these records available to the Government.

The first point Mr. Diesel took exception to was my statement that:

> "A conglomerate acquired a shipbuilding company 8 months into the fiscal year. For the first 8 months before the conglomerate took over, the shipyard reported a $28.9 million loss, although it had reported respectable profits in prior years. For the remaining 4 months of the year, under the conglomerate management, the shipyard reported a $4.4 million profit. That shipyard division then showed record high profits for the 2 following years, and a relatively stable high profit for the third year, before profits began to decline. The conglomerate did not really institute many significant changes in the shipyard. By and large the work was done by the same people, following roughly the same procedures. However, the profit reports indicated that conglomerate management had once again turned an unprofitable operation into a profitable one. The question arises whether the large writeoff prior to acquisition by the conglomerate was realistic and whether the profit projections for the next few years were overly optimistic. If so, they would ultimately have to be corrected by reported losses as contracts are completed."

My testimony is correct. It is a fact that the only year for the past ten years that Newport News has reported an overall loss is for the first eight months of 1968 just preceding the merger with Tenneco, and that this was followed by two years of a great increase in reported annual profit which more than compensated for the $28.9 million loss reported during the first eight months of 1968. The Newport News income from operations over the past ten years reported in company annual reports was:

Year	Newport News Income From Operations (Dollars in Millions)	
1965	$ 17.2	
1966	11.1	
1967	11.6	
1968 (First 8 months)	-28.9 (Loss)	
1968 (4 months after purchase by Tenneco)	4.486	
1969	21.057	
1970	25.657*	$ 29.430**
1971	19.201*	23.394**

Year	Newport News Income from Operations (Cont'd) (Dollars in Millions)
1972	$ 17.890
1973	5.820
1974	10.941

* Source: Tenneco 1974 Annual Report

** Source: Tenneco 1971 Annual Report. Difference between 1970 and 1971 Newport News earnings data represents restatement of income due to a change in method of allocating office expenses.

The second point Mr. Diesel took exception to was my statement that:

> "Another contractor had his profit reduced by $4.2 million a year simply because his share of the parent corporation's expenses was retroactively increased by a factor of 20. And flexibility doesn't stop here. If the corporation had wished, it could have reduced the defense subsidiary's share of these costs, and consequently increased the profits for the year."

Mr. Diesel stated that the method used in allocating corporate (home office) overhead to Newport News is based on a standard promulgated by the Cost Accounting Standards Board which became mandatory for Newport News on January 1, 1974. He said that earlier, the company conformed with the standard in its proposed form. The fact is that, as discussed below, the company did not apply the standard to 1970, 1971 and 1972 operations until 1973, when the company decided to apply the then proposed standard retroactively, before it became mandatory for the future. The standard makes no provision for retroactive application.

My testimony was based on the Tenneco 1972 home office expense allocation to Newport News which was retroactively increased by a factor of 20 in 1973 before the Cost Accounting Standard on home office expense became mandatory. The case is a clear example of defense contractor flexibility in financial reporting. It is further amplified by the differences in Newport News profit figures for 1970 and 1971, as reported by the 1971 and 1974 Tenneco annual reports cited in the preceding table. In the 1974 report the Newport News profit figures previously reported for 1970 and 1971 were reduced by $3.8 million and $4.2 million, respectively. This difference is due to a restatement in income due to the change in home office expense allocations. The Defense Contract Audit Agency (DCAA) has recommended that the retroactive change in home office expense allocation should not be allowed as a cost on Navy contracts. This issue remains to be resolved and currently is under consideration by the Navy.

E. Overhead. I cited three basic reasons for Newport News' financial problems on new construction contracts and said that, "These are

contractor-responsible items, not the fault of the Navy." One of the reasons I cited was that "the overhead increased from about 56 percent when Tenneco bought Newport News in 1968 to the current overhead of about 86 percent." Mr. Diesel devoted three pages to taking exception to this sentence and concluded: "Like many of Admiral Rickover's statements, his inferences with respect to our overhead rate are very misleading. Much of the six year increase has been caused by the Government and relatively little has been fully within our control."

Contrary to Mr. Diesel's opinions in this matter, I find my testimony regarding overhead to be factual and Mr. Diesel's treatment of this matter to be misleading. For example, Mr. Diesel pointed out that one category of overhead expense, indirect labor costs expressed as a percentage of direct labor costs, had increased 5.6 percentage points from 1968 through 1974. He suggested that most of this increase was due to Government actions. However, during the years between 1968 and 1974 the annual ratios of indirect labor costs to direct labor costs were much higher than the ratio for 1974. The table below illustrates the increases that were actually incurred during these years:

	Indirect Labor Costs Expressed As A Percentage of Direct Labor Costs	Percentage Point Increase Over 1968
1968	20.4%	-
1969	23.2%	2.8
1970	27.5%	7.1
1971	31.3%	10.9
1972	32.6%	12.2
1973	32.2%	11.8
1974	26.0%	5.6

By allowing the ratio of indirect labor costs to direct labor costs to increase substantially during the period 1968-1973, Newport News incurred substantial additional costs. The reduction of indirect labor costs as a percentage of direct labor costs which Newport News management achieved between 1973 and 1974 amply demonstrates that some of the elements of overhead at Newport News are controllable by the shipyard's management. A study by the Supervisor of Shipbuilding shows that had Newport News taken such action to control indirect labor costs at the outset, approximately $37 million in indirect labor costs and associated fringe benefit costs could have been avoided. It should also be noted that if shipbuilding contracts were of the cost-plus type, the shipyard would have had little or no incentive to make such reductions in indirect labor costs.

Although the company did not have control over several of the factors that contributed to the large increase in overhead rates at Newport News, the fact remains that, as I testified, higher overhead rates did contribute to the company's financial problems and, under the terms of Navy shipbuilding contracts with Newport News, these items are generally contractor-responsible.

II. INORDINATE GOVERNMENT INSPECTION, DIRECTION AND CONTROL

Mr. Diesel in his testimony complained that the Government over-specifies and over-inspects Navy ships. In response to his allegation, I testified:

"Based on long years of experience, I can assure you that the Navy simply cannot rely on contractors to act always in the Government's interest in technical matters, sir.

"Let me cite some recent examples at Newport News so that you will get some idea of what might happen if the Government didn't have people in the shipyards checking on the work.

"After the shipbuilder completes a ship's compartments he requests inspection by the Government. In the case of the nuclear-powered guided-missile frigate SOUTH CAROLINA, the Government inspectors noted over 10,000 unsatisfactory items in 510 compartments which were turned over to the Navy for inspection. Subsequently Newport News agreed to correct almost all of these deficiencies.

"The nuclear attack submarine L. MENDEL RIVERS has its anchor chain locker located in a main ballast tank. During the final tank inspection by the Navy, the Navy inspector noted that some nuts were not properly secured to their bolts. The shipbuilder was notified of this discrepancy, yet he closed the tank without correcting the deficiency. The issue had to be raised by senior Supervisor of Shipbuilding representatives with company officials before the company would correct this deficiency. If the deficiency had not been corrected, at a later time the anchor and chain might have been lost when the ship anchored. The ship could have been cast adrift and perhaps have run aground.

"During the final drydocking of the SOUTH CAROLINA, prior to sea trials, Navy inspectors determined that Newport News had not properly removed marine growth from the ship's propellers. After the shipbuilder had cleaned the propellers properly, numerous cracks were visible in the weld areas on both propellers. Had not the Navy inspectors identified these cracks and caused their proper repair, the propeller welds might have failed.

"Newport News has in many instances neglected to properly paint and preserve steel structures during the lengthy construction period of surface ships despite continual urging to do so by the Supervisor of Shipbuilding. This lack of proper preservation can lead to rusting and pitting of structural support members thus weakening the ship's structural strength and reducing its useful life. It has taken continual pressure and action by the Navy's Supervisor of Shipbuilding to keep this item under control.

"Steel hull Navy ships usually have aluminum superstructures in order to reduce ship weight. Because of the differences in the electrochemical properties of aluminum and steel, an insulation material must be placed in the areas where the aluminum superstructure joins the steel hull. In the CALIFORNIA and SOUTH CAROLINA initial

construction the shipbuilder did not properly insulate the hull and steel attachments to the aluminum superstructure. At sea this deficiency would have resulted in accelerated deterioration of the aluminum structures. It was only through continued pressure by the Navy inspection force that this deficiency was eventually corrected.

"Another current example involves design in some NIMITZ class carrier piping systems which open to the sea. The Government specifications clearly require that Newport News shall design these piping systems so that no seawater will be pushed through the pipes to the machinery spaces during a 30° ship roll. The way Newport News has designed these systems, seawater can fill the piping due to wave action even with no ship roll. Newport News contends that they interpret the specification to mean they only have to design for a "static roll" and that it is not up to them to design for waves. Newport News reasons that the specification did not say the ship had to withstand a 30° roll simultaneously with waves. Now, I ask you, would you not expect waves to be present if a ship is rolling 30°? How else would a 95,000-ton ship experience a 30° roll?

"Under these circumstances is it any wonder that contract specifications have become voluminous and that the Navy has had to tighten its administration of its technical requirements? Certainly there will be cases of defective specifications and these can and are compensated for under the contract. However, to argue that shipbuilders will provide a satisfactory ship if left alone and subjected to minimal specifications and supervision is to fail to recognize the realities of the situation. To fulfill its responsibilities, the Navy must continue to establish firm technical requirements and see that they are met.

"It is easy for the shipbuilder to say the Navy should not do so much checking during ship construction. But it should be thoroughly understood that the shipbuilder generally guarantees the ship for only 6 months after its delivery. The Navy, on the other hand, has responsibility for the ship throughout the remainder of its life, sometimes 30 years or more."

Mr. Diesel's statement attached to your letter said that he regards these examples as "misleading." He said: "Taken together, they are out of focus and constitute an unfair reflection on the dedication and integrity of our work force." He then devoted 10 pages to discussion of the examples I cited. The thrust of his comments is that virtually all of the deficiencies were inconsequential or invalid; the company would have found and corrected the deficiencies actually needing correction without Government inspection; or that the deficiencies were due to inadequate Government specifications or outside the contract requirements.

Mr. Diesel's deprecation of quality control deficiencies is of itself cause for concern. If top shipyard management excuses such deficiencies, how can the workers be expected to take pride in building a ship that complies with contract requirements? I consider that Mr. Diesel's discussion of the examples I cited in my testimony presents a wrong picture of the actual situation. Therefore, I will discuss each of these items in some detail.

A. Deficiencies on the SOUTH CAROLINA. Newport News' procedures for completion and submission of ship's compartments to the Government for inspection require a series of five inspections by the company: structural completion inspection; strength and tightness test; inspection prior to installing insulation or ceilings; yard mechanical inspection; and compartment final inspection. By Newport News' own work procedures the purpose of final inspection is to verify that "all work, except excluded items, is complete and in good condition and that the quality of workmanship is satisfactory." "Excluded items" refers to such items as pilferable equipment which are not installed at compartment turnover. These inspections are separate from tests to determine proper operation of all ship's systems. Therefore, the compartment final inspection is not intended nor expected to uncover deficiencies affecting the ability of the ship to perform its intended mission. Before turning a compartment over to the Government for inspection following the company's final compartment inspection, all deficiencies are supposed to have been corrected, including those that Mr. Diesel might consider are of a "cosmetic nature" since the shipbuilder is required to present a finished product to the Navy.

Contrary to Mr. Diesel's statement, the Navy compartment inspections on the SOUTH CAROLINA did not exceed the contract provisions. The Supervisor of Shipbuilding did not agree to limit his inspection to a statistical sample. Additionally, the Navy's initial lists of discrepancies submitted to Newport News for correction even cited the contract specification, plan or other contractual requirements violated. On the average, each of the more than 500 compartments had about 20 deficiencies when inspected by the Navy. Since the Navy inspection in which the Navy found these deficiencies came after the final inspection and notification by Newport News that the compartments were complete, I fail to see the basis of Mr. Diesel's assertion that "many of the deficiencies would have been corrected by Newport News prior to delivery of the ship as a matter of normal routine--even if they had not been cited by the Navy inspectors."

To give you a better understanding of the deficiencies involved, I have selected the deficiency list from a compartment of average size and complexity, an electronic cooling equipment room, which had 22 specific deficiencies cited by the Navy inspectors. Larger compartments such as machinery rooms, had deficiencies which were much more serious and far larger in number. Conversely, smaller and simpler spaces, such as voids and fan rooms, had fewer deficiencies. The 22 items cited by the Navy inspectors in the electronic cooling equipment room are listed below:

(1) rubber painted over in ventilation valves and flapper; (2) thermometer glass broken and not calibrated in air conditioning system; (3) no damage control card holder mounted on bulkhead; (4) 14 valves not labeled; (5) no hand grab provided for closing overhead valves; (6) electrical outlet does not have proper label plates installed; (7) water stands in compartment because deck drain not flush with deck; (8) some nuts missing on void hatch cover; (9) water seeping from under insulation on pump suction line; (10) no drip pan provided for duplex strainer, water will damage insulation; (11) underside of loudspeaker brackets not painted; (12) missing instruments on filter board; (13) lagging on 90° ell on electronic cooling water supply not vapor sealed; (14) temporary cable tags installed and one cable tag missing in electrical wireway; (15) pump suction gage board union leaking; (16) duplex strainer has no operating instructions or label installed; (17) diagram and operating instruction not posted; (18) inside of heat exchanger foundation not welded; (19) insulation on leg of heat exchanger not sealed; (20) rust under pump foundations; (21) deck drain valve closing slot damaged and not square; (22) bolts cocked--head of bolt not square to surface. (Items 6 and 12 above were later deleted by the Navy.)

These remaining items violate contract requirements and must be corrected before a compartment is truly complete. Since Mr. Diesel states that "virtually all were either inconsequential or invalid," it is clear that if the Navy had not inspected the compartments and required the company to correct these deficiencies, the Navy would have received a ship with most of the deficiencies still outstanding. As a result of the Navy's making such inspections and insisting that such deficiencies be corrected on the CALIFORNIA, the follow ship, SOUTH CAROLINA, was more adequately prepared. The CALIFORNIA had about 13,000 deficiencies listed when her compartments were inspected. Further, many of those in the CALIFORNIA were of greater significance such as tile completely missing from the deck of one compartment; some incomplete structural welds; etc.

As Mr. Diesel noted, I did, upon return from the SOUTH CAROLINA first sea trial, "congratulate Newport News and the SOUTH CAROLINA ship's force for the excellent preparation of the ship for the trial." I believe that Navy surveillance during construction of the ship and insistence that deficiencies be corrected as they were discovered, significantly contributed to the final result.

B. Anchor Chain Locker. As I stated in my testimony and as Mr. Diesel also stated, some nuts were not properly secured to their bolts in the anchor chain locker located in a main ballast tank in the submarine L. MENDEL RIVERS. Mr. Diesel correctly notes that these nuts and bolts do not secure the anchor or chain to the ship.

However, Mr. Diesel stated that a "Navy Inspector did not discover this problem...During the company's inspection prior to tank closure, it was noted that about 15 percent of the 354 fasteners did not protrude all the way through the nylon insert portion as is required. Though the nuts were otherwise fully engaged, they lacked one or two thread turns of proper placement."

He also said "it was agreed with the Supervisor of Shipbuilding's representative on the job that the replacement would be deferred...for some unknown and as yet unexplained reason, this practical agreement at the working level was overturned by the Navy at a higher level... In my judgment this episode typifies the Navy's tendency to exaggerate the importance of minor items and to demand performance of work according to schedules which often are neither the most reasonable nor the most economical."

The Supervisor of Shipbuilding, Newport News disagrees with Mr. Diesel's assessment of this problem. Since the anchor chain locker is located in a ballast tank outside the pressure hull and below the waterline, access to it for inspection requires the ship to be in dry dock. Since it is near the stern, it is subject to propulsion induced vibrations. The self locking features on the nuts engage the last several threads; thus the nuts must be fully engaged on the bolts to stay tight. If this problem was noted "during the company's inspection prior to tank closure", the Supervisor of Shipbuilding does not understand why the company made no such statement when the tank was officially presented to the Navy for inspection as being complete on April 10, 1974. The Navy inspector who discovered this problem during that inspection pointed out the deficiency to a company supervisor and asked that it be corrected. The next day the company's representative stated the tank would be closed and did so. The Navy inspector then issued a Quality Deficiency Record (QDR) in which he mentioned that this deficiency might cause a noise problem in the ballast tank.

Upon receipt of this QDR, the company submarine construction manager requested that a senior Supervisor of Shipbuilding representative examine the discrepancy with him. On 12 April 1974, the Deputy Supervisor, a naval Captain with 17 years experience in the operation, construction, and maintenance of submarines, examined the fasteners with the construction manager. Based on this examination, the Deputy Supervisor advised the construction manager that he considered the ship could not be certified as ready for sea with the fasteners improperly engaged. The Deputy Supervisor noted that if due to vibration, the bolts were to come loose, or fall out, the anchor chain might become fouled which would result in a malfunction in releasing or retrieving the anchor. He also noted that if an access plate came adrift, it could possibly block a portion of the ballast tank flood port and reduce the rate at which the ballast tank could be blown free of seawater in the event of the need for emergency surfacing of the submarine.

The company construction manager expressed the opinion that correction of the discrepant fasteners could be safely deferred until the next docking of the ship. However, the Navy representative did not agree to such a deferral. The shipyard initiated corrective action about 48 hours after the deficiency was reported by the Navy. Corrective action was completed in less than 18 hours, well before the ship was otherwise ready for undocking.

C. Inspection of Propellers. In my testimony I cited an example of cracks discovered in SOUTH CAROLINA propeller welds as a result of the Navy insisting on recleaning of the propellers.

Mr. Diesel stated: "The facts are that the propellers were of a Navy design and that neither the cleaning of the propellers nor the discovery of the cracks resulted from Navy inspection."

He went on to state that "the cracks were attributable to a deficient Navy design."

It is true that the propellers are of a Navy design. However, their procurement, manufacture, and delivery in satisfactory condition were the responsibility of Newport News.

Mr. Diesel's contention that the cause of the cracks is primarily the result of a deficient Navy design is not a correct assessment of the situation.

The weld detail design in question that was used on DLGN 36 Class propellers is the same as that used for propellers for ships of the DE-1040, DE-1052, and DE-1078 Classes. Most of these propellers, which have now seen considerable shipyears of service, have experienced no weld cracking problems. In those cases where problems were experienced, Navy investigations into the causes have revealed that cracking was caused by improper fabrication techniques, specifically lack of a full penetration of the weld or improper fitup before welding.

Mr. Diesel's contention that the recleaning and discovery of the cracks were not the result of Navy inspection is not consistent with the records or reports by the Navy personnel involved.

On 28 June 1974, the SOUTH CAROLINA (DLGN 37) was dry docked for underwater body work. The following day, a Newport News construction supervisor advised a Navy Quality Assurance Specialist that the propellers had been cleaned and were ready for inspection. No cracks were reported to the Navy by the company. The Navy Quality Assurance Specialist inspected the propellers and reported that they were not adequately cleaned. The Newport News construction supervisor agreed and stated he would re-clean them. On 5 July 1974, the Newport News supervisor was again reminded by the Navy Quality Assurance Specialist of the need to clean the propellers properly. On the morning of 6 July, the Navy Quality Assurance Specialist returned to the dock and observed water coming from welds on the propellers. While it is probable that company employees also observed this water, which was then readily visible, if the Navy Quality Assurance Specialist had not insisted on proper cleaning of the propellers, the weld defect would not have been found. Meanwhile, seven days of dry dock time had elapsed since Newport News had presented the propeller for final Navy acceptance in unsatisfactory condition.

In all, 31 cracks were discovered. Newport News requested approval to use a bronze epoxy putty type filler in lieu of rewelding the cracked welds. The filler was not approved by the Navy. Newport News, however, expressed concern that rewelding the cracked welds would delay the scheduled undocking, but proceeded with repair welding.

At 0800 on 12 July, all but 4 cracks had been welded and undocking was set for 1400 that day. During the morning of 12 July, Newport News' representatives again requested permission to make repairs on 2 cracks with the bronze putty, but the Navy disapproved the request since the bronze putty was not considered satisfactory for service.

That morning, the Navy docking officer noted a workman in the dry dock carrying a container of the bronze putty. He asked the Newport News construction manager why this putty was brought to the propeller worksite. The ship construction manager reaffirmed that he knew the putty was not approved and stated that its presence at the worksite was a result of his prior expectation that its use might be approved. Several hours subsequent to this, the Navy Quality Assurance Specialist left the worksite for lunch. The shipyard then put the bronze putty into the remaining crack, and subsequently the ship construction manager informed the Navy docking officer that the ship was ready for undocking without mentioning the bronze putty. The Navy Quality Assurance Specialist went to the propeller to inspect the final weld and discovered that bronze putty had been used in lieu of repair welding. Rather than causing delay in undocking to remove the bronze putty which had hardened by that time, the Navy agreed to the undocking.

In October 1974 the ship had to be dry docked at Newport News for another reason and the propeller was reinspected. The bronze putty had fallen out of the crack thus refuting the repeated prior assurances by Newport News that the bronze putty was fully satisfactory. During dry docking in a naval shipyard subsequent to delivery of the ship, many more cracks were found, appearently the result of the improper original welds failing in operation. The Navy had to remove the propellers and replace them with spares while the original SOUTH CAROLINA propellers were reworked in the Norfolk Naval Shipyard shops.

In my testimony I did not raise the issue of the propeller welding deficiencies as an example to show poor Newport News workmanship and subvendor control. I can understand how the welds passed the Government inspection at the vendor's plant, as Mr. Diesel cited, and receipt inspection at Newport News, since the cracks apparently developed in service. The point I testified to, which this example clearly shows, is that Navy inspection is necessary to ensure that deficiencies are identified and corrected by contractor personnel, who are under great pressure to deliver a ship at minimum cost to the company.

D. Insulation Between Aluminum and Steel. Mr. Diesel stated that my reference to improper insulation between the steel hull and aluminum superstructure "also conveys very misleading impressions." He concluded that "this insulation problem was, in reality, a specification problem." Mr. Diesel is not correct. Nor does he indicate the magnitude of this problem, which was not fully corrected in the CALIFORNIA by Newport News, but was eventually mostly corrected in the SOUTH CAROLINA as a result of continued pressure by the Navy.

Specifications require that steel and aluminum be insulated from one another with three coats of paint. For joints exposed to weather or dampness, they also require a layer of insulating tape followed by caulking. Specifications also require that bolts exposed to the weather be made of corrosion resistant steel. The purpose of these requirements is to avoid galvanic corrosion between dissimilar metals.

Navy inspection of the CALIFORNIA in June 1973 noted that Newport News was not meeting these specifications. In many cases throughout the weather-deck areas: exposed bolts made of non-corrosion resistant steel were being used; joining surfaces were not properly painted; insulating tape was not present; caulking was not applied, and in some cases where it was applied, it was applied over rusted or unpainted areas. If not corrected, the Navy would have had to make extensive repairs after the warranty period to correct the resultant corrosion. The seriousness of this situation was indicated by the following list of deficiencies sent to Newport News by Navy Quality Deficiency Record, number DLGN 36-909-256 of 22 June 1973:

"1. The insulation tape between the steel coaming and aluminum bulkhead under the butt weld at 1-74-1 and 1-74-2 has never been installed or has been burned away by welding done subsequent to the installation. In many areas the insulation tape is recessed in the joint. Reference (a) requires the tape to extend beyond the joint.

"2. The fitup between the aluminum structure and the steel coaming is so poor in many areas that a seal can only be achieved by applying a bead of epoxy at the top of the joint on the interior side. The entire area of the lower weather side of the faying surfaces are exposed to the elements. Rusted areas are already in evidence.

"3. The door installed at 1-157-2 is typical of the majority of doors. Large areas of the required paint coatings have been removed from the faying surfaces where weld beads have been ground away and other grinding has been done for fairing purposes. Exhibit 1

"4. Numbers of rivets in the coaming joints were noted to be installed in a 'cocked' and unsightly manner, leaving a gap under rivet head that will be difficult to seal and imposing abnormal stresses on the fasteners. Exhibit 2

"5. A large number of welds were noted to be of very poor quality, with a lack of adequate fusion, irregular shape and contour, inadequate penetration, and areas of undercut, with a profusion of weld spatter surrounding the bead. Exhibit 3

"6. Steel door hooks are being attached directly to the aluminum structure. The specific hook installed at 1-154-2 has heavily encrusted rust through its entire length. Exhibit 4

"7. The vertical aluminum spray shield installed on the inboard side of, and adjacent to the shore power connection boxes, has been installed against the steel coaming without the required primer coatings.

"8. The majority of pipe hangers were noted to be installed without the required CRS (corrosion resistant steel) bolts, nuts, and washers, and without paint coatings and tape between the faying surfaces.

"9. There is no visible evidence that required paint coatings have been applied between the faying surfaces of doors and coamings. There is evidence that caulking compound has been applied over bare metal, deteriorated paint, and rusted areas of the coaming.

"10. The entire coaming area at every deckhouse does not appear to have been coated with anything more than the original primer. Numerous weld burn scars in the coaming have never been touched up with a resulting rusted condition.

"11. There is evidence of rust, deteriorated paint, and poor welding at the bottom flange of the access door to Compartment 1-65-O-M.

"12. The interior side of the door flange at 1-95-O-L has been sealed with epoxy and paint has been applied over caulking.

"13. The weather side of the ventilation duct coaming joint at 1-112-2 has been sealed with epoxy."

The exhibits referred to were photographs of the conditions described.

Mr. Diesel alleged that the specifications, "with respect to insulation, if interpreted literally, were simply impossible of practical accomplishment in all cases." To rectify the poor specifications, he continues, both contractor personnel and the Supervisor of Shipbuilding personnel "had agreed to depart from the literal specification requirements." That is not a correct statement. The Navy did not agree to a specification departure. There were three Quality Deficiency Records issued on this subject. They were dated 12 June, 22 June and 5 October 1973. The photographic evidence for the cited deficiencies shows that although some of the missing insulation had been burned away by welding, as Mr. Diesel states, this welding was in virtually all cases repair welding by Newport News to correct prior unsatisfactory welds made by Newport News. Thus, Mr. Diesel's comments that the insulation was "unavoidably affected by the heat from welds at nearby locations" and "impossible of practical accomplishment" are not factual. The problem was avoidable had the initial welds been properly made. Mr. Diesel also neglects to mention the extensive deficiencies cited that had nothing to do with welding, such as insulation tape missing on the steel pipe and cable clamps that attached to the aluminum structure.

Mr. Diesel stated that, "the Navy accepted the ships and Newport News was not required to rip out or rework these so-called 'deficiencies' as would have been required if they had resulted from faulty workmanship." In fact, correction was required by the Navy and was accomplished in many cases. The three Quality Deficiency Records noted above were all accepted for correction by the company. The Supervisor of Shipbuilding in a letter of 4 January 1974 to Mr. Diesel expressed the Government's grave concern over the matter and the company's slow response to the Quality Deficiency Records and asked to be advised of the company's course of action. On 21 March 1974, Mr. Diesel reported by letter that the rework on two of the Quality Deficiency Records had been accomplished and that Newport News was proceeding on the third. Mr. Diesel's letter of 21 March 1974 and his again repeated statement that the Navy accepted the CALIFORNIA without taking exception to uncorrected joint deficiencies is in error. The Navy did take delivery of the CALIFORNIA with some unsatisfactory deficiencies, including improperly caulked joints and non-corrosion resistant steel bolts on exposed surfaces where corrosion resistant steel was required, since it was not acceptable to delay the entire ship for correction of these deficiencies. However, these deficiencies were cited during Preliminary Acceptance Trials by the Navy Board of Inspection and Survey (Items 1K040HB and 2K062HB), in the ship delivery letter to Newport News (dated 14 February 1974) and in official notification of the Navy's intent to achieve a cost reduction (contract modification Field Modification Request 856 of 8 April 1974) under the contract for this failure to meet contract requirements. In the case of the SOUTH CAROLINA, which followed CALIFORNIA, Newport News Shipbuilding and Dry Dock Company did respond more fully to the Supervisor's request for corrective action on this issue. The fact that these deficiencies were mostly corrected in SOUTH CAROLINA I attribute to the diligence of Navy inspectors and the Navy representatives at Newport News.

Finally, in concluding his remarks, Mr. Diesel comments that the problem is a "specification problem" and that the "Navy in effect conceded" this by changing the design. Such a conclusion is not correct. The Navy in fact did change the method of joining steel decks and aluminum deckhouses for the later DLGN 38 Class ships. But this change was because of an advance in technology, not a defective specification. The new joint design used an explosively bonded aluminum to steel joint. The Navy did not change the method of attaching steel pipe and cable clamps to aluminum structure. The galvanic corrosion prevention features specified for CALIFORNIA and SOUTH CAROLINA, which Newport News essentially met in SOUTH CAROLINA, have been commonly and successfully used in older class destroyers for about 20 years.

The only record of a specification clarification in this area requested by Newport News was a request for Navy concurrence that insulation tape should protrude about 1/32 of an inch beyond the joint. The Navy concurred. The specification required that it protrude, but did not specify a length.

E. Painting. Mr. Diesel dismissed my comment concerning instances where Newport News neglected to paint and preserve steel structures properly during the lengthy construction period of surface ships, on the basis that disagreement between Newport News and the Navy "has essentially been over the timing and scheduling of the painting." Mr. Diesel further stated: "Every ship built by Newport News is completely and properly painted in accordance with contract requirements." He stated that while my "statement that lack of proper preservation can lead to deterioration of the ship is obviously correct, Newport News knows of no instance where this has occurred in its shipyard."

Mr. Diesel apparently has forgotten that the bottom paint on both the SOUTH CAROLINA and her sister ship the CALIFORNIA was unsatisfactory and that the old paint had to be completely stripped and the bottoms grit blasted and completely repainted in a naval shipyard a few months after ship delivery. Less than two months after delivery of the SOUTH CAROLINA, approximately 20 percent of the bottom paint had peeled off, often in large sheets. Samples of the peeled paint with rust on the bottom layer, which were made available to Newport News, showed that the paint had been put on by Newport News over rusty surfaces, which caused it to peel.

On interior surfaces, paint may be applied over rust and dirt and still look good for several months, possibly lasting even through the 6-month warranty period. But if the initial metal surfaces are not properly painted and preserved, the Navy will either have to strip the paint down to bare metal later, as had to be done on the bottom of the CALIFORNIA and SOUTH CAROLINA and repaint, or put up with rusting structure and peeling paint throughout the life of the ship. That is why the ship specifications specify how paint must be applied and surfaces preserved.

On 9 May 1973 the Supervisor of Shipbuilding sent a letter to Newport News raising the issue of improper painting and cited unresolved Quality Deficiency Records dating back to September 1972, which identified lack of surface preservation, or paint applied over rust, dirt, grease, and other contaminants in violation of specification requirements. Concern was expressed by the Navy that there would be inaccessible areas which could not easily and properly be re-preserved later in ship construction. This concern was strengthened by the likelihood that difficult re-preservation work would not be done since Newport News procedures at that time prohibited any expenditure of man-hours for re-preservation "unless approved by the Project Manager or his designated representative."

Newport News responded that the "hull structure preservation met specification requirements" but acknowledged unsatisfactory conditions on the SOUTH CAROLINA, stating that these conditions are "atypical" and "have not been caused by improper care and preservation during early stages of construction." Finally, the letter indicated that the Shipyard would continue its existing practice.

The Supervisor of Shipbuilding did not consider that this response was acceptable and noted that Newport News was not in fact meeting specifications. He therefore wrote to Mr. Diesel on 30 August 1973, stating in part:

> "I can only interpret reference (b) as a rejection of my contention that a problem exists and as a statement that the company intends to do nothing further about it.
>
> "I consider this entirely unsatisfactory. The fact remains that Shipyard personnel have painted over many areas of rust in SOUTH CAROLINA. The Shipyard in fact did not properly clean and preserve these areas in the way of welds and in other places where the initial primer had been burned, scraped or otherwise destroyed. The Shipyard in fact did complete considerable outfitting, including installing machinery, equipment, wireways, etc., in spaces prior to cleaning and preserving adjacent rusting structural areas. The Shipyard then found it extremely difficult to properly clean these structural areas after outfitting. In many areas, the rust is now showing through. I am also concerned about the areas not properly prepared where the rust may yet show through after delivery."

Mr. Diesel's reply of September 20, 1973, while stating that Newport News felt the Navy had in the past expected excessive preservation, stated:

> "The company fully recognizes that structural surfaces must be properly cleaned and preserved and that this must be accomplished in a timely manner, in accordance with the specifications. Over the past several months our management has emphasized this problem with the trade supervision and more experienced painters have been assigned in this problem area. In addition, our second shift effort has been specifically strengthened in this area. Improvements have resulted from our continuous emphasis on proper cleaning and preserving structural surfaces and with the realignment of personnel. The actual time to clean and preserve the structure in the ships under construction will be in a sequence prior to outfitting the space unless sound economic practices indicate otherwise.
>
> "Furthermore, you may be assured that, upon delivery of the ships, paint work will meet contractual requirements."

The Navy's concern over the improper painting practices in the SOUTH CAROLINA was so great that Mr. Leighton and I personally inspected many of the spaces involved with the prospective Commanding Officer and a Newport News senior waterfront manager. The Commanding Officer and the Supervisor of Shipbuilding continued to press Newport News for corrective action. As a result, Newport News exerted a major effort to correct the deficiencies in the SOUTH CAROLINA. It was a difficult job involving crawling in tight spaces, and the commitment of extra workers to do the rework. If proper attention had been given initially to preservation, much of the extraordinary rework effort would have been avoided.

Many of the deficiencies in Newport News painting practices of the past few years have now been corrected. However, continuing Navy surveillance has been necessary to achieve this result; this was the point made in my testimony.

F. Ship Roll Design Question. Mr. Diesel stated that the Newport News design of the NIMITZ "fully satisfies" the requirement that "relief escape piping overboard be run in such a manner that seawater will not be introduced into the system during a 30 degree ship roll." But he also stated that "if the Navy had intended us to consider wave action it would have said so--and would have specified the size of the waves." It just so happens that on the initial sea trials of the NIMITZ, moderate wave action caused seawater to be introduced into this system with almost no roll of the ship. Newport News has contractually contended that the design modifications which must be made to make this system perform satisfactorily in service are the responsibility of the Government. Mr. Diesel stated: "To the extent there is a contractual problem concerning the overboard escape and relief piping, it stems directly from the Navy's failure to state in the specifications what it now says it wanted in addition to the 30 degree roll protection."

Under the circumstances I consider the questions I asked in my testimony to be perfectly appropriate; namely: "Now, I ask you, would you not expect waves to be present if a ship is rolling 30°? How else would a 95,000-ton ship experience a 30° roll? Under these circumstances is it any wonder that contract specifications have become voluminous and that the Navy has had to tighten its administration of its technical requirements?"

III. THE NIMITZ/EISENHOWER CONTRACT NEGOTIATION (COST ESTIMATES)

During Mr. Diesel's testimony before the Seapower Subcommittee, he stated that Newport News had originally proposed 41.9 million man-hours for construction of the NIMITZ. He said that after considerable negotiations Newport News proposed 36.7 million man-hours, and that at the time of his testimony 40.8 million man-hours were expected to be expended on the NIMITZ when completed, with an additional 2 million man-hours attributable to changes made in the course of construction. He indicated this showed that the Newport News original construction estimate was accurate. He testified that: "There was no serious effort by the Navy to demonstrate that our estimate was erroneous or unrealistically high--just that the resultant cost was regarded as unpalatable to Congress."

Mr. Leighton stated in his testimony: "The fact that the final man-hours charged to the NIMITZ will be close to the original Newport News estimate is not ... an indication of the validity of the original Newport News estimate. Rather, it is visible proof of the serious decline in productivity that has occurred in the last several years at Newport News."

Mr. Diesel took exception to this statement and devoted four pages to a discussion of the negotiations of the NIMITZ/EISENHOWER contract, which were conducted two years before he arrived at Newport News, in order to "demonstrate that the testimony of the Navy's witness on this point is erroneous." Mr. Diesel further stated that he had discussed the NIMITZ/EISENHOWER negotiations "to illustrate what I consider to be a very serious problem in Navy procurement--the practice of presenting misleading shipbuilding cost estimates to Congress and the public." This is a serious charge and a wrong one. As I will discuss, Mr. Diesel's presentation is inaccurate.

Mr. Diesel stated that during NIMITZ contract negotiations the Navy refused to discuss the NIMITZ estimate on a line item basis even though detailed discussions with the Navy on a line item basis had been successful in the past in resolving differences, and such a technique had resulted in a highly successful contract for the ENTERPRISE. The fact is that during detailed discussions between the Navy and Newport News on the ENTERPRISE contract, disagreements on the overall elements of man-hours, labor rates, overhead rate, material dollars, shiftwork and overtime premium persisted even though the ENTERPRISE was approximately 50% complete when negotiations to definitize the letter contract were conducted. Agreement on a line item basis was not achieved and agreement was finally reached only on a total price basis.

In the case of the NIMITZ, the Navy review effort was built on the ENTERPRISE negotiation experience with certain important differences. The first difference was that the Navy decided to set aside the standard Navy Work Breakdown System and to utilize only the Newport News Cost Class System. The second difference was the decision to document completely the massive review effort by the Navy. Considering the fact that a portion of this documentation is held by Newport News, I am surprised that apparently Mr. Diesel has not been made aware of this.

Hundreds of questions that were generated by the Government team when it reviewed the Newport News NIMITZ proposal were submitted officially and in writing to Newport News. Newport News' answers to those questions were provided officially to the Government. At the negotiation meeting on May 27, 1970 referred to by Mr. Diesel, Navy representatives stated: "The Government Team very early during the proposal analysis established a dialogue with your cost engineers and the technical people by a series of written questions and letters and personal visits. This dialogue has been most helpful in providing a better understanding of the details of your basic estimate." Considering the depth of review and the many detailed questions and answers, contrary to the description of the negotiations furnished by Mr. Diesel, the specific areas of Navy concern on the Newport News NIMITZ proposal were well known to Newport News. At the same May 27, 1970 negotiation meeting, the Navy reiterated in detail many of the major problem areas.

Considering the Navy's negotiation experience on ENTERPRISE and considering the answers provided by Newport News to the many Navy questions on the NIMITZ proposal, it was obvious to the Navy that if the Navy and Newport News were ever to agree on the NIMITZ/EISENHOWER contract, it would have to be on a total price basis. However, throughout the lengthy negotiations neither party insisted on any specific negotiation approach. During the negotiations, there were offers by both parties to "negotiate line for line," which both sides well knew would add months to the negotiations. It was obvious to all present that neither side really wanted to enter into a line by line negotiation, since it was clear that such an approach would not resolve the basic issues involved in the negotiations.

Mr. Diesel stated that at the May 27, 1970 meeting, "Navy representatives stated that the Navy estimate was based on historical costs--partly from the aircraft carrier ENTERPRISE and partly from the aircraft carrier KENNEDY, with allowances for inflation." Mr. Diesel also stated that "Newport News disagreed strongly with the basis of the Navy's estimate." The Navy had no independent estimate for negotiation purposes; rather, the Navy established a position based on a detailed evaluation of the Newport News proposal. Historically, Newport News has utilized past performance on previous ships as a basis for estimating costs for a new ship. The NIMITZ proposal was done the same way, and Mr. Diesel should be aware of this fact.

Mr. Leighton's statement, quoted above, concerning productivity on the NIMITZ is correct. If there had not been a drop in productivity, the final man-hour total for the NIMITZ would have been well below the Newport News original estimate.

The two major elements involved in estimating the amount of labor required to construct a ship are the scope of work and the labor factor. The scope pertains to quantity of material used in building the ship (i.e., tons of

steel, feet of cable, piping, etc.). The labor factor is the number of man-hours required to work a unit of material (i.e., to put up a ton of steel, or lay a foot of cable or pipe).

The labor factors proposed by Newport News for the NIMITZ generally were not a major issue during the NIMITZ negotiations. The Newport News proposed labor factors were primarily based on their performance on the KENNEDY and the ENTERPRISE; the Navy accepted them. In its evaluation of the Newport News proposal for NIMITZ, the Navy took exception to the scope of many of the 10,000 line items. The Navy analysis of the NIMITZ proposal revealed that the expected scope of effort in terms of quantities of material, such as feet of pipe and cable and tons of steel required to build the NIMITZ were overstated by Newport News, and therefore the man-hours to do the work (using KENNEDY and ENTERPRISE factors) were overstated. Thus the Navy's man-hour position was lower than that of Newport News.

As things turned out (as verified by a comparison with the current Newport News proposal for construction of the CARL VINSON), the scope in the NIMITZ proposal was overstated by Newport News, while the labor factors proposed by Newport News and accepted by the Navy were low. Newport News productivity on the NIMITZ did not match the levels achieved on KENNEDY and ENTERPRISE from which the labor factors were calculated. Had productivity remained at the level achieved by Newport News on the earlier carriers, the man-hours expended on the NIMITZ would have been far below the original Newport News estimate.

This is not my first experience with Newport News presenting a misleading record of Navy contract negotiations. I am sure you will recall that a similar issue over Newport News preparing inaccurate records of negotiations arose a few years ago in relation to the DLGN 38 Class contract.

Mr. C. L. Willis of the Newport News Contracts Division delivered the DLGN 38 Class contract signed by Newport News to Rear Admiral Woodfin, who was then Director of Contracts for the Naval Ship Systems Command, together with a letter dated 22 November 1971 signed by Mr. L. Ackerman, who was then President of Newport News. In his 22 November letter, Mr. Ackerman made Newport News' acceptance of the DLGN 38 Class contract contingent upon an enclosure--a 31 page memorandum also dated 22 November 1971 but signed by Mr. Willis which was purported to be a record of the negotiations. The Willis memorandum contained numerous errors and presented a one-sided, self-serving picture. To accept it would have qualified Newport News' acceptance of the contract--making the contract itself subject to the interpretations and comments contained in the Willis memorandum. Recognizing that such a qualified acceptance would undermine the contract itself, and that it was an apparent attempt by Newport News to establish from the outset a basis for subsequent claims, Rear Admiral Woodfin rejected the executed contract together with the Willis memorandum. The documents were physically returned to Mr. Willis, on 22 November 1971, the same day they had been presented to the Navy.

Mr. Willis thereupon offered an alternate letter, also signed by Mr. Ackerman, which accepted the contract unconditionally. Apparently Mr. Willis had brought the second letter along in anticipation that the Navy might not accept a contract executed subject to other conditions or "understandings". However, Rear Admiral Woodfin was concerned that simply returning the Willis memorandum to Newport News, and letting Newport News substitute an unconditional acceptance of the contract, would not adequately protect the Government. The Navy was still in the position of having been put on notice by the Willis memorandum, with its many errors and misstatements. Rear Admiral Woodfin was concerned that as long as this memorandum existed, it might later be cited by Newport News as evidence of what actually happened during the negotiations, long after the Navy personnel who participated in the negotiations and knew the actual facts had gone on to other jobs. He was also concerned that Newport News might try to use the Willis memorandum subsequently as the basis for a claim.

After consultation with counsel and others, Rear Admiral Woodfin decided that to clear the record it would be necessary for Newport News management to provide written assurance that the contract as written reflected the full intent of the parties and to specifically acknowledge that the Willis memorandum did not accurately reflect what actually transpired during the negotiations and was, in fact, inaccurate in virtually all respects. He drafted letters which would be acceptable to the Navy in this regard.

On 23 November 1971, at Rear Admiral Woodfin's request, I called you about this matter. This was the first time you and I had any business dealings. I told you that Newport News had attempted to condition its acceptance of the DLGN three ship contract upon interpretations contained in a Newport News document which was purported to be a memorandum of the contract negotiations; that the Newport News document contained many inaccurate statements; and that contracts must stand on their own and not be contingent on some outside document. I told you that in all my experience I had never before seen a case where a company attempted to make a contract contingent upon a set of its own minutes of negotiations, much less minutes containing many inaccuracies and presenting the contractor's view. I said I was sure you knew nothing of this matter but suggested that you call Mr. Ackerman to get his side of the story and then call me back.

About an hour later you telephoned me to say you had talked to Mr. Ackerman and that you agreed that Newport News was wrong in what they had done. I read to you the draft letters prepared by Rear Admiral Woodfin and they were subsequently dictated to your secretary while you were on the telephone. You then told me that you had read the draft letters and that you agreed with them. You said you would have Mr. Ackerman come to Washington that night to sign them. You stated that you had no prior knowledge of this matter and had not been involved in it in any way.

A few hours later Rear Admiral Woodfin received a call from Mr. Ackerman who was in Racine, Wisconsin. Mr. Ackerman said he was flying to Washington

later that day to sign the two letters which I had discussed with you and asked Rear Admiral Woodfin to tell Mr. Willis, who was in Washington, to prepare the letters for his signature and he would sign them at the Washington National Airport that evening. In view of his tight schedule, arrangements were made for the Navy's contracting officer to meet Mr. Ackerman at the airport to get the signed letters.

Late in the afternoon of 23 November 1971, Mr. Willis notified the contracting officer that Mr. Ackerman would sign the first letter which unconditionally and unqualifiedly accepted the DLGN contract, but that the second letter would have to be modified to delete the statement that the Willis memorandum was "inaccurate in virtually all respects".

Mr. Ackerman spent the evening of 23 November and 24 November 1971 attempting to get agreement to make the deletion he desired. He stated that the Willis memorandum had been prepared at his direction but that he had merely glanced at it. After being urged to read the Willis memorandum, he read it and agreed that it was inaccurate. However, Mr. Ackerman did not agree that the words "in virtually all respects" were correct. He said he had asked that the memorandum be prepared, not as a basis for future claims, but as a Newport News defense against future disallowances by the auditor.

After considerable discussion, during which errors in the Willis memorandum were pointed out and discussed, Mr. Ackerman finally agreed that he had handled this entire matter improperly, and that the letters were correct. He then signed both letters that you had previously approved.

As a result of this incident, Newport News officials and you (i) acknowledged that Newport News had not handled this matter properly; (ii) accepted the DLGN 38, 39, and 40 contract on an unconditional and unqualified basis; (iii) reaffirmed that the contract as written and executed constituted the entire understanding and agreement of the parties and that there were no extra contractual agreements or understandings oral or written which would be the basis of any Newport News claim against the Government; (iv) acknowledged that the 22 November 1971 memorandum by Mr. Willis did not in fact reflect what transpired during negotiations and was inaccurate in virtually all respects; and (v) certified that all copies of Mr. Willis' memorandum had been destroyed. It was therefore agreed by you, Mr. Ackerman and me during a subsequent meeting in my office that the issue was closed and would not be raised again.

In view of this background I am sure you can understand my surprise when I learned that in a meeting with the Deputy Secretary of Defense on 3 February 1975 and in a subsequent meeting with senior Navy civilian and military officials on 4 February 1975, you stated that you had a set of minutes of the negotiation meetings for the DLGN 38 Class contract which would prove your allegations that the negotiations had been conducted

improperly. You said that you were considering sending this memorandum to the Seapower Subcommittee of the House Armed Services Committee. You said that Mr. Ackerman had signed a letter concerning these minutes and that you would not have let him sign it had you seen it. One of those present at the meeting said it was obvious that you were implying improper action on the part of the Navy and were attempting to use this correspondence as leverage to convince senior officials to reopen the DLGN 41 option pricing agreement, and perhaps to reopen the whole DLGN 38 Class contract pricing as well.

I do not understand how you could expect to resurrect Mr. Willis' 22 November 1971 memorandum and establish credibility for it when, with your prior concurrence, Mr. Ackerman had officially notified the Director of the Navy's Contract Division that:

> "After reviewing Mr. Willis' memorandum, I agree with you that it does not adequately reflect what transpired during the negotiations and is inaccurate in virtually all respects ..., I want to confirm that all copies of Mr. Willis' memorandum have been destroyed."

However, because of this experience the Naval Sea Systems Command Negotiating Team responsible for trying to negotiate resolution of the differences between the Navy and Newport News on the DLGN 41 option was concerned as to what sort of a one-sided record Newport News might attempt to make of the DLGN 41 option negotiations. Before starting the negotiations they tried to get the Newport News Negotiating Team to agree that any contractual language agreed to would be the official record and that any other record would be on the following basis:

> "In order to have free and full discussion of the many different matters concerning the negotiation of the DLGN 41 option, the parties agree not to maintain any transcripts, records or minutes of the negotiation other than working notes, except that if the parties agree to record any such part of discussions it will be in the form of minutes which will be signed by both parties."

Several attempts were made to arrive at mutually agreeable language, but Newport News contract officials insisted on retaining the company's "right" to make any unilateral record of the negotiations the company desired. Finally, the Navy's Negotiating Team concluded the only way they could protect the Navy was to have a court reporter make a verbatim transcript of all sessions. Copies of these transcripts have been furnished to Newport News.

IV. MANPOWER AND PRODUCTIVITY

A. Manpower. In his testimony, Mr. Diesel contends that delays in Government furnished components for the NIMITZ were a principal cause of

the reduction in force of 4500 employees from 1968 through 1970. To support this, Mr. Diesel, in his comments on my testimony, said that if during 1968 and 1969 the ship was being built to a scheduled mid-1972 delivery date there would have been 4400 men working on the NIMITZ in January 1969--seven months after the actual keel laying--rather than the 1750 there actually were. I assume the manpower figures Mr. Diesel cited do not include indirect people.

Mr. Diesel states that in 1967, prior to award of the NIMITZ contract, the company planned to man the ship as follows:

EVENT	MAN LOADING
Keel Laying	2000
Keel Laying + 10 months	5400

He stated NIMITZ was never manned to meet a mid-1972 delivery date.

I have been unable to find in Navy files the manning plan Mr. Diesel discussed. However, the manning plan dated 16 November 1966, which Newport News furnished the Navy in support of Newport News' qualifications for undertaking the NIMITZ contract, showed a much slower planned buildup of manpower. That plan showed about 835 men at keel laying, about 2350 men seven months after keel laying, and about 3000 men ten months after keel laying, excluding indirect people.

The NIMITZ keel was laid on 22 June 1968, 48 months before June 1972. Since this allowed five months longer than the original span of time to build the ship, an even slower buildup of manpower could possibly have been accommodated. The actual manning, excluding indirect people, was about 875 men at keel laying, about 1750 men seven months after keel laying, and about 2000 men ten months after keel laying.

The manning plan Mr. Diesel discussed would have required a much faster buildup of manpower on the NIMITZ than Newport News had achieved on prior carriers. In this regard it is worthy of note that based on data provided to the Navy by Newport News, at the time of laying the keels of USS ENTERPRISE in February 1958, USS AMERICA in January 1961, and USS JOHN F. KENNEDY in October 1964, the manning levels on each of these carriers was in the range of 400 to 500, nowhere near the 2000 man level Mr. Diesel states was planned for the NIMITZ. At the time of actual NIMITZ keel laying in June 1968, the manning level was, as I stated previously, about 875 men per day, essentially the same manning level included on the Newport News 16 November 1966 manning plan for keel laying.

Through the end of 1968 when Mr. Diesel says there were 1750 men per day working on NIMITZ (7 months after keel laying) the manning levels on the

NIMITZ were greater than the manning levels on the ENTERPRISE for the first seven months after keel laying in January 1958. Consequently, even though the NIMITZ manning buildup was less in 1969 than the manning buildup for the ENTERPRISE construction, at the equivalent time in her construction, manning on the NIMITZ through the end of 1968 could have supported a mid-1972 delivery based on Newport News' actual performance on the ENTERPRISE, assuming worker productivity was comparable to what it was in 1958.

The thrust of my testimony of this matter was that almost half of the shipyard's 4500 man reduction in force to which Mr. Diesel had referred in his testimony, coincides with the reduction in manning on commercial work during the same period and that as I said in my September 23, 1974, testimony to the Seapower Subcommittee:

> "It is true that the manning level on the NIMITZ in 1970 would have been somewhat higher had the NIMITZ remained on its original schedule; but it would have been impossible for the NIMITZ to have absorbed most of the 4500 people Newport News layed off from mid-1968 to the end of 1970."

The facts available to me support my testimony on this matter.

Mr. Diesel also took exception to my testimony that due to the late delivery of nuclear components, construction of the NIMITZ proceeded on the basis of building in areas other than the reactor compartments. I stated:

> "You should understand that the reactor compartments in the NIMITZ make up less than 10 percent of the length of the ship so that the other 90 percent of the ship was available for work."

Mr. Diesel stated:

> "Admiral Rickover's comment is somewhat like saying that the foundation and the first floor of a 10-story building make up only 10 percent of the height. One not familiar with shipbuilding might reasonably infer that the NIMITZ reactor components were not significant and could be lowered into the ship at virtually any stage of construction. This is far from the case. Although the reactor compartments make up less than 10 percent of the length of the ship, it is a relatively meaningless statement in this context."

Mr. Diesel's comparison of installation of components in the NIMITZ reactor compartments to construction of the foundation and first floor of a 10-story building is "a relatively meaningless statement in this context", to use his language. The fact is that the ship was built from keel to flight deck all the way from the bow to the stern with two large accesses left open for late installation of reactor plant components. These openings and the compartments affected only about 10 percent of the ship; the remainder was available for work.

Mr. Diesel was correct when he stated that each of the openings approximated 6400 square feet. However, the following table shows that these openings represented only about 10 percent of the work areas on the decks they penetrated:

Deck Penetrated	Area of Deck	Percent Opening in Deck Area
3rd Deck	110,700 square feet	11.6%
2nd Deck	112,200 square feet	11.4%
Main (Hangar) Deck	133,100 square feet	9.6%
Gallery Deck	186,500 square feet	6.9%
Flight Deck	208,000 square feet	6.2%

Mr. Diesel also stated: "Roughly 200 compartments in the area of the openings could not be constructed and approximately 50 more adjacent compartments had to be left incomplete." There are over 2500 compartments in NIMITZ, thus the 250 compartments affected were less than 10 percent of the total.

The effects of the delays in Government furnished reactor plant components on construction of the NIMITZ and the EISENHOWER were negotiated, and Newport News was compensated in the contract as modified by bilateral contract agreement executed in February 1973 after all the late Government furnished reactor plant components were installed in the NIMITZ.

B. Productivity. Mr. Diesel stated that "problems associated with manpower and productivity are not basic causes of our financial problems but rather symptoms of fundamental shortcomings in the Navy's ship procurement process." He devoted six pages to, in effect, denying that in the several years before my testimony there was a serious decline in productivity at Newport News. He even suggested that in some ships the officers and crew go "out of their way to hinder the contractor in the performance of his work." However, Mr. Diesel goes on to state: "Notwithstanding all I have said on the subject of productivity, we are mindful that this problem--and we know it is a problem--demands constant vigilance."

I agree with this latter statement by Mr. Diesel. As I commented earlier, the reduction in productivity during the manpower build-up was a major cause of the decision by Newport News in 1973 to abandon their plan to increase the employment level to over 30,000. In December 1972, the Defense Contract Audit Agency issued a report concerning Newport News' labor productivity in nine selected shops which showed idleness rates averaging 28.7%, with a high of 34.8%. Everyone familiar with shipbuilding knows that idleness rates aboard ship are generally even higher than in shops.

The auditors calculated that one extra percentage point of idleness at Newport News costs about $2.3 million per year.

In discussing Mr. Leighton's testimony that "negative learning" has occurred in submarine overhauls and conversions, Mr. Diesel stated that "Mr. Leighton was obviously referring to a set of theoretical learning curves provided to the Navy during a negotiation in 1974 as Company Confidential Data." Mr. Leighton was not referring to such "theoretical learning curves", which he has never seen, but to actual return man-hours for some SSBN overhauls and POSEIDON conversions.

V. NEWPORT NEWS COST CONTROL SYSTEMS

Although Mr. Diesel contends that the Newport News cost control system is adequate, independent reviews by the Naval Sea Systems Command, the Assistant Secretary of the Navy (Financial Management), the General Accounting Office, and the Defense Contract Audit Agency all concluded that cost control procedures at Newport News were inadequate. Despite repeated Newport News statements of good intention, not much progress has been made in effecting improvements.

VI. PURCHASING PRACTICES

Because of the largely non-competitive nature of shipbuilding, because the Government bears a substantial share of cost overruns, and because about 40 percent of the shipbuilder's cost of a warship consist of subcontracted effort, the Government has a large stake in the cost of materials procured. It cannot rely solely on shipbuilders to act always in the Government's interest. My experience has been that shipbuilders recognize and pursue the potential for substantial savings in purchasing their own facilities and equipment, but do not put the same care into purchasing material for Government work. This is one of the major reasons Government review of major shipyard procurements is essential.

VII. NAVY CHANGE ORDERS AND SHIPBUILDING CLAIMS

My testimony included the following colloquy:

> "Admiral Rickover. Under present contracts, the Navy can unilaterally order a change, but to avoid a claims situation, agreement as to the impact on the shipbuilder's costs and schedule must be bilateral. Shipbuilders who want to keep their books open for later claims have sometimes either refused to price the change or have included terms so unreasonable as to make bilateral agreement impossible. So the Navy project manager is faced with a problem. He can either go ahead and order the change to be performed and then sit back and wait for the claim--and then we are right back into the problem you mentioned--or he can decide not to do it and have the change made by a Navy yard after the ship is finished, sir.
>
> "Mr. Mollohan. I would think this would be an unconscionable thing to do. I was shocked at what you said earlier about a case you spelled out.
>
> "Admiral Rickover. Do you want some facts on a particular case? Mr. Leighton has been handling some of these recently.
>
> "Mr. Leighton. I can understand Mr. Mollohan's interest here. Let me give you an example of the extent to which shipyards have carried their position on changes and contractual matters in general.

"A shipyard quoted $500 to develop and print two rolls of 35 millimeter classified photographic film, and then insisted on reserving the company's rights regarding potential impact on ship delivery. Obviously, developing two rolls of film could not possibly impact ship delivery. But the shipbuilder had instructed his people not to accept any change order without a price reopener, so that the company could subsequently cite all changes in a delay and disruption claim at the end of the contract.

"This kind of action by the shipbuilder obviously complicates and frustrates prompt settlement of changes. If the Navy sticks by its policy of prepricing changes, and shipbuilders continue to frustrate early settlement, then the changes the Navy feels are necessary to improve the operating and safety characteristics of ships may not be accomplished at a time when the work could be done at minimum cost.

"Admiral Rickover. Let me cite another case. The Newport News Shipbuilding & Dry Dock Co. is responsible for the design of the high-speed submarine. They have designed the ship under a separate design contract.

"They made a mistake in the design. As a result of that mistake, we have to change some foundations on that ship. The cost of the actual work was about $20,000. In addition to this cost, the shipyard claimed the impact of delay on the ship was over $1 million. It took us months of negotiation to settle that change at $800,000.

"Mr. Mollohan. You mean they made the mistake in design?

"Admiral Rickover. Yes, sir; they made the design mistake.

"Mr. Leighton. We should make it clear. They made the mistake in the design contract. On that contract the Government is its own insurance agent. Therefore, on the shipbuilding contract the Government was responsible contractually for the shipbuilder's mistake on the design contract. Contrary to much of the testimony you have received, the Government has not transferred all of the risks to the shipbuilders. This was a case where the Government accepted full responsibility for the ship designer's mistake.

"Admiral Rickover. There are two points to make here. First, it took a long time to settle this change because the Navy refused--correctly I think--to accept the contractor's proposal for the cost of delay without adequate supporting data. The shipbuilder said there would be 6 weeks delay on the ship and that this would cost over $1 million. We asked to see the rationale for this delay

and cost. He initially provided only a limited amount of general rationale and no detailed data. It was only after months that the shipbuilder provided enough detailed data to enable the Navy to negotiate a settlement. Second, this is really the only change of any significance on that ship. The shipbuilder claims to be losing money on that ship contract. He implied to you that Government changes are a major source of his financial problem. However, there have been almost no changes of significance on that ship, yet he still says he is losing money."

Both of these examples illustrate the great difficulty the Navy has in negotiating prompt settlement of changes in shipbuilding contracts at Newport News. Concerning my point that it was only after months of negotiations that Newport News provided enough detailed data to enable the Navy to negotiate a settlement for the cost of correcting a Newport News mistake under a design contract for the SSN 688 high speed attack submarine, Mr. Diesel stated:

"We identified this particular problem on November 19, 1973. Our complete pricing proposal was submitted to the Supervisor of Shipbuilding on December 5, 1973, at which time we proposed a ceiling price adjustment of $1,076,198 and a delay of 42 days. This proposed ceiling adjustment and delay was concurrently provided to Admiral Rickover in a telephone conversation. At the request of both Admiral Rickover and Admiral Gooding the Company agreed to proceed with the work on the basis that a fully priced modification to the contract would be negotiated by the parties within the following two weeks.

"On December 7, 1973, the company and the Navy held the first negotiation meeting. On December 20, the Navy offered us a ceiling price adjustment of $22,655 for the work caused by this change with no recognition of any delay; we obviously refused. On January 9, 1974, after further negotiation meetings held during the Christmas Holidays, the Navy offered $358,800 and we obviously refused again.

"After 20 separate meetings with the Navy, a tentative agreement in the amount of $900,000 and 42 days delay was reached with the Supervisor of Shipbuilding in May 1974. This agreement was revoked by NAVSEA. After this revocation, negotiations were reconvened and on July 2, 1974, agreement was reached on a ceiling price of $800,000. Finally on July 26, 1974, a modification to our contract was executed increasing the ceiling price by $800,000. Of the 42 days delay claimed by the Company in its very first proposal on December 5, 1973, all 42 days of the delay were eventually recognized and agreed to by the Navy.

"I cannot understand how this example can possibly suggest either a 'greatly exaggerated' claim or a foot-dragging attitude by Newport News."

Mr. Diesel's description of this matter has omitted some important points:

The cost of the work, exclusive of delay costs, required to correct the mistake was agreed to by Newport News and the Navy to be $22,777. The difficulty in negotiating the total amount involved was to determine the length of delay in delivery of the ship that would result and the cost of that delay. Since the Government was contractually responsible for delays caused by this work, I persuaded Mr. Diesel to get started on the work at once in order to minimize the actual delay. Admiral Gooding and I both promised Mr. Diesel that the Navy would pay for the cost of this work. We arranged to authorize the Supervisor of Shipbuilding, on December 6, 1973, to issue immediately a supplemental agreement to the contract at a maximum price of $1.2 million, including a maximum delay of 6 weeks to be negotiated downward only. This would have allowed Newport News to collect money immediately against the job while the Supervisor of Shipbuilding and Newport News were negotiating a final price.

Newport News refused to accept the maximum price agreement and instead elected to proceed with the work at their own risk without any change order while negotiating the final amount. Both parties expected these negotiations to be settled quickly. However, negotiations took longer than expected in order to reconcile the large difference between the company and Government estimates. On 21 January 1974 Newport News raised their cost estimate over 20 percent to $1,304,198.

In the 31 January 1974 meeting which you, Mr. Diesel, and Mr. Corcoran had with the Deputy Secretary of Defense you cited this change order at length as an example of the difficulty Newport News has with change orders. You said that Admiral Gooding and I had said that Newport News would get their money but they hadn't, even though they had done the work and that the Navy was offering to pay only 60 percent of the Newport News costs. At that meeting you did not mention that Newport News could have at any time accepted the $1.2 million maximum priced agreement which would have made cash immediately available to Newport News while negotiations were going on. Nor did you mention that 10 days previously, on 21 January, Newport News had raised their price by more than 20 percent to over $1.3 million. It was only after extensive discussions and analyses of the information provided, that in July 1974 the Navy reached agreement with Newport News on an increase in the ceiling price of $800,000, 61.5 percent of the amount Newport News in January claimed the Navy owed them.

CONCLUSION

In preparing this letter I have confined my comments to what I consider the principal issues raised by Mr. Diesel. To have addressed each and every point with which I disagree, would only obscure the basic issues.

It is indeed unfortunate that this exchange of letters has become necessary. I have taken the considerable time from my work required to respond to Mr. Diesel's statement. One familiar with the facts would recognize that it is misleading and that many of the charges are inaccurate. But these charges against the Navy cannot remain unanswered.

Although my letter is long, I hope that you will personally take time to read and understand it rather than rely on an "executive summary" prepared by a member of your staff.

Mr. Diesel has repeatedly attempted to attribute essentially all of Newport News' financial problems to the Government, and to discredit those who present information to the contrary. Apparently his efforts are designed to influence both Government and corporate officials who may not be entirely knowledgeable of the facts. Apparently Newport News officials believe they will be paid more on their claims if they can discredit the Navy and its administration of shipbuilding contracts. Moreover, by attributing their problems to the Government, shipyard officials cast their own performance in a better light to their superiors and to Government officials than is warranted.

Having failed in getting the Navy, the Department of Defense, or the Congress to agree to convert present contracts into cost-plus type contracts, Newport News is currently embarked on the submission of massive claims in the attempt to recover all its cost plus a profit, regardless of the fact that much of the increased costs is its own contractual responsibility. It presently appears that the total requested ceiling price adjustment of these claims and "requests for equitable adjustment" may be on the order of $800 million or more.

There are many problems in any complex long term contracts, such as those for Navy shipbuilding. That is why the contracts include specific provisions for changes and adjustments--but on the basis of facts. I have consistently supported payment by the Navy of the costs of changes and delays for which the Navy is contractually responsible. However, I also support Navy insistence on maintaining the integrity of its contracts and on requiring that contract requirements be met. The Navy should not assume responsibility for obligations that are the shipbuilder's contractual responsibility.

As Mr. Diesel's statement has been widely circulated throughout the Government, including Members of Congress, I am providing similar distribution for my comments herein.

I have no desire to belabor the issues raised by Mr. Diesel or you, nor do I see any point in doing so. Rather I desire that the Navy be permitted to devote its efforts to resolving outstanding issues and proceeding to have its ships built. I intend to direct my efforts to that end. I urge that Tenneco, on its part, direct the efforts of Newport News personnel at all levels to the difficult and complex task of designing and building ships in full accordance with contractual requirements.

Sincerely,

H. G. Rickover

H. G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

6 Aug 1975

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Comments on issues raised by Tenneco and Newport News Shipbuilding and Dry Dock Company officials concerning Admiral Rickover's September 23, 1974 testimony before the Seapower Subcommittee of the House Armed Services Committee

Encl: (1) My ltr dtd 6 Aug 1975 to Mr. N.W. Freeman, Chairman of the Board of Tenneco, Inc.

1. On April 17, 1975, Mr. N. W. Freeman, Chairman of the Board of Tenneco wrote to me commenting on my September 23, 1974 testimony before the Seapower Subcommittee of the House Armed Services Committee. Attached to his letter was a statement prepared by Mr. J. P. Diesel, President of Newport News Shipbuilding and Dry Dock Company, a division of Tenneco. Mr. Diesel's statement contains detailed comments on my testimony. Tenneco has provided copies of Mr. Diesel's statement to the Secretary of Defense, the Deputy Secretary of Defense, to you, and to others.

2. Enclosure (1) is my response to Mr. Freeman. As I point out in enclosure (1), it is unfortunate that this exchange of letters has become necessary. It has taken considerable time from my work and the work of others to respond to Mr. Diesel's statement, which is misleading and in many respects inaccurate. Since large sums of Government funds are at stake, his charges against the Navy must not go unanswered.

3. Mr. Diesel has repeatedly attempted to attribute essentially all of Newport News' financial problems to the Government and to discredit those who present information to the contrary. Apparently these efforts are designed to influence high Government officials--who cannot be entirely knowledgeable of all the facts--to pay more on Newport News' claims than the company is legally entitled to under the terms of its shipbuilding contracts.

4. I am providing you additional copies of my response and respectfully request that you make them available to the

Secretary of Defense, the Deputy Secretary of Defense, and to others as you deem appropriate.

H. G. Rickover

H. G. Rickover

Copy to:
Under Secretary of the Navy
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Operations
Chief of Naval Material
The General Counsel of the Navy
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

18 AUG 1975

MEMORANDUM TO ADMIRAL MICHAELIS

Subj: Proposed Revision to Navy Procurement Directive (NPD 1-401.55, July '75)

1. Thank you for your memorandum of 11 August 1975 which forwarded the latest draft of the proposed revision to Navy Procurement Directive (NPD) 1-401.55. I was pleased that you decided not to change the definition of "claims" nor relax the safeguards applicable to them. Also, the addition of a new provision, NPD 1-406.51 which requires that even formally issued change orders shall be subject to the same NPD requirements as claims if they involve difficult or complex legal, factual or fiscal issues, will be beneficial.

2. Concerning the proposed, new language which is to be inserted as NPD 1-401.55(c)(2)a, some clarification is needed. This new policy statement directs that "...where Navy actions (or inactions) alleged by the contractor, after appropriate evaluation, constitute a change, the Contracting Officer should promptly formalize such constructive change(s) in writing...".

3. The above language would appear to require the Contracting Officer to concede liability for certain constructive changes even though the parties are unable to agree on an equitable adjustment in contract price and delivery for the item in question. I do not believe it is to the Government's advantage to acknowledge responsibility except when agreement can also be reached on price and delivery. If such agreement cannot be reached, the claim may be referred to the Armed Services Board of Contract Appeals where the contractor bears the burden of proving legal entitlement. He should not be released from that burden unless the claim can be completely settled.

4. From conversations between my staff and members of the Office of the General Counsel, I understand that the proposed change to NPD 1-401.55(c)(2)a is not meant to authorize or direct Contracting Officers to issue unpriced contract modifications. Instead, it is intended to encourage finalization of fully negotiated, priced modifications. To clarify this intent and to preclude arguments to the contrary, additional language should be inserted. I suggest that after the words "in writing", the following be added: "as soon as the parties have negotiated an acceptable adjustment to the contract price and delivery clauses."

5. I would appreciate being informed of what action you intend to take with regard to my recommendation.

H. G. Rickover

Copy to:
Commander, Naval Sea Systems Command
NAVSEA 02
NAVSEA OOL

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

18 MAR 1976

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Certification of Newport News Claims

Encl: (1) My memo for the Deputy Commander for Contracts, Naval Ship Systems Command dtd 30 Jun 72

1. I understand that you plan to meet with Mr. Diesel, President of Newport News, on March 19, 1976 to discuss shipbuilding claims. I recommend you take up the subject of claims certification as the first item of business at that meeting.

2. Navy Procurement Directives (NPD 1-401.55) require that, prior to evaluating contractor claim submittals, Contracting Officers must obtain an affidavit from the responsible senior company official certifying that, to the best of his knowledge and belief "...(i) the facts in the claim are current, complete, and accurate and, (ii) the conclusions in the claim accurately reflect the material damages or contract adjustments for which the Navy is allegedly liable." Newport News provided such an affidavit on its initial claim under the SSN 688 Class contracts but has refused to provide affidavits on its other claims.

3. This requirement was implemented because prior experience indicated that contractors often submitted grossly inflated claims and then revised and resubmitted them whenever the Government's evaluation of amounts actually owed did not turn out to be enough to satisfy the contractor. Enclosure (1) presents an example of one specific case and is similar to what the Navy is facing with Newport News today. A possible fraud action in this case is still being investigated by a grand jury.

4. In addition to refusing to provide the required affidavits on its subsequent claims, now it appears that Newport News is even trying to nullify the one affidavit it did provide. The situation is this:

- On July 2, 1975, Newport News submitted a $142.5 million claim on its SSN 688 Class submarine contracts.
- On October 3, 1975, Newport News, at Naval Sea Systems Command (NAVSEA) request, provided the required affidavit for the above claim; NAVSEA began evaluating the claim.

- In February 1976, NAVSEA, based on a preliminary analysis, concluded that a provisional price increase of about $10 million could be made on the claim.

- On March 3, 1976, you met with Newport News officials and informed them that the company would shortly be receiving a provisional payment of about $10 million.

- On March 8, 1976, Newport News submitted a revised claim, now totaling $270.1 million, covering these same ships; the required affidavit was not submitted, and has not yet been requested.

Although the revised claim is voluminous, comprising 15 books, a cursory review by NAVSEA personnel indicates that the revisions are not confined to additional items of alleged Government responsibility arising after submission of the first claim. Many of the elements of the first claim, which the company certified as being "current, complete, and accurate " have also been revised substantially.

5. I believe it is now essential for the Navy to stand firm on its requirement for this affidavit and the other safeguards it has instituted to protect the public from unwarranted expenditures. If the Navy makes a provisional payment on the revised and uncertified SSN 688 claim or if it proceeds to evaluate other uncertified Newport News claims in the face of pressure from Newport News, the Navy will have set a precedent for all other contractors to push for higher settlements than the legal merits of their claims would justify. The Navy can then look forward to years of wasted effort evaluating exaggerated and constantly changing claims.

6. I know you are being urged to "improve relations" with shipbuilders. However, the problem is not one of human relations; it is strictly a matter of money. Newport News appears to want the Navy to ensure the company's profitability. This could well require a payment of more than the amount they are entitled to under their contracts. The Navy, however, can only pay claims on their legal merits. Payments on any other basis would require the Secretary of the Navy to exercise his authority to grant extra-contractual relief under P.L. 85-804.

7. By applying pressure and threatening not to build ships, the company apparently believes it can get paid more on its claims than it could otherwise get. Until contractors are

convinced that the Navy intends to handle claims properly and in accordance with established safeguards, they will continue to submit inflated claims and attempt to negotiate settlements with senior Defense officials for more than they are legally entitled.

8. In summary, the Navy policy should be to expedite claim settlements on the basis of legal entitlement. However, this cannot be accomplished until Newport News submits realistic claims and certifies that the claims and supporting data are current, complete, and accurate. I recommend you relate this to Mr. Diesel. If he refuses to submit such realistic certified data, I recommend the Navy suspend its evaluation of Newport News claims and not grant provisional price increases against their claims until the matter is resolved to the Navy's satisfaction. In the long run this will expedite resolution of the claims problem.

9. I would appreciate being informed of what action you take in this regard.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy (I&L)
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

24 MAR 1976

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY
(INSTALLATIONS AND LOGISTICS)

Subj: Relations with Newport News Shipbuilding and Dry Dock Company

1. I understand that you and other senior Navy officials are to meet with the Deputy Secretary of Defense this week to discuss how the Navy might improve relations with Newport News. In view of our past discussion I thought you might like to have my views on this subject. Therefore I have summarized them in this memorandum.

2. The basic question in the Newport News situation is whether the Navy will take responsibility for financial problems at Newport News regardless of the company's responsibility and performance under its Navy shipbuilding contracts.

3. Most of the financial problem on Newport News Navy shipbuilding contracts is the outgrowth of company actions taken several years ago. In 1971, Newport News projected a need to build up manpower from 18,200 early in 1971 to over 30,000 employees in 1973 to meet its commitments on existing Navy contracts. In the fall of 1972, Newport News signed a contract for three Liquified Natural Gas Carriers (LNG's) and announced plans to build a new yard for construction of these and other merchant ships. At that time, Newport News had an employment level of about 27,000 people and was still building up its manpower. Newport News and Tenneco officials stated at the time that they expected to make manpower for the commercial work available within their expected 30,000 employment level due to a projected decline in Navy work starting in mid-1974.

4. To assuage Navy concern over the potential impact of the commercial work on Navy work, the Chairman of the Board of Tenneco in a letter dated February 12, 1973 assured the Navy that:

"Tenneco will not allow performance of work on non-Navy contracts to interfere with the performance of work necessary to meet Newport News commitments on Navy contracts."

5. In early 1973, shipyard productivity decreased and there was a large increase in fabrication errors--apparently caused by the lower skill level of the new hires. In 1973, Newport News announced that it had abandoned its plans to build up to the 30,000 employees which it had projected were necessary to meet commitments on Navy contracts. Since that time the employment level has decreased to the present level of about 22,000.

6. The decline in productivity and increase in rework during the work force expansion caused an increase in the number of manhours required to complete present Navy contracts. To accommodate this increase in manhours and the shortfall in manning, Newport News stretched out Navy ship construction schedules. Under the contract terms these manpower problems and the costs of escalation on the deferred work are the responsibility of the shipyard.

7. The shipyard still does not have sufficient trained manpower to meet existing commitments on Navy contracts, and is currently faced with having to build up the manpower assigned to commercial contracts or delay the commercial ships. Newport News is claiming that the Navy is responsible for all the delays and higher costs which accrue on Navy work.

8. Newport News assembled a large team to prepare claims on Navy shipbuilding contracts. To generate bases for these large omnibus claims, employees have been encouraged to search out and report actions and events that might be used as a basis for a claim against the Navy. Even minor technical details or problems are now treated as contractual matters.

9. Settlement of contract changes has also become increasingly difficult. Often the company either refuses to price the changes in advance, quotes an excessive and unsupported price, or demands the right to reopen contract pricing later for other reasons such as the "cumulative impact of contract changes."

10. Recently Newport News has accelerated its efforts to have the Navy accept responsibility for financial problems at Newport News. For example, during the past year:

- o Newport News stopped work on the CGN 41, claiming that the contract option for construction of CGN 41 is invalid. A U.S. District Court directed that the company continue construction while the parties attempted to negotiate their differences and while several issues in dispute were submitted to the Comptroller General for rulings. When the Comptroller General ruled in the Navy's favor the company disagreed and returned the dispute to court.

- o Newport News continued to refuse to accept most contract changes without reserving rights to "cumulative impact" thus making it impossible to preprice most changes. This created the large backlog of unpriced changes about which Newport News repeatedly complains.

- o Newport News stated, in a February 20, 1976 letter to the Chief of Naval Operations, that it was considering stopping work on the CVN 70 and not entering into new Navy shipbuilding contracts. The company repeated that statement in a March 15, 1976 letter to Congressman T.N. Downing which has been published in the Congressional Record.

11. Newport News has now submitted to the Navy the large omnibus claims it has been assembling for over a year. These shipbuilding claims now total over $894 million in requested ceiling price adjustments and cover every active Navy shipbuilding contract at the shipyard in addition to several completed contracts. Newport News has been utilizing these claims as the basis for getting the Navy to accept responsibility for the financial problems at the shipyard. However:

- a. Newport News refuses to certify these claims as being current, complete, and accurate as required by Navy Procurement Directives. From preliminary Navy review it appears that claims are inflated.

- b. Newport News typically does not show a relationship in these claims between alleged Government actions and increased costs and delays. It simply lists a series of alleged Government actions, and then claims that the Government is responsible for all increased costs and delays.

12. While Newport News is owed some money on its claims, the company, by the nature of its claims submissions, has made it very difficult and time consuming to sort out the items for which legal entitlement exists. It is reasonable to conclude from the manner in which the claims have been presented that the company believes that actual entitlement under these claims is considerably less than the amount the company is seeking.

13. In his March 15, 1976 letter to Congressman Downing, the President of Newport News stated "I need to bring all the pressure to bear that I can for a prompt and equitable resolution of the differences between the company and the Navy. Time has run out." Yet, over $665 million (three-fourths of the total) of Newport News' claims were submitted or revised within the last two months. Moreover, it was Newport News' decision to store up small changes and other items for use in large omnibus claims rather than adjudicate them on their merits at the time they arose.

14. The problem with Newport News is strictly one of money. Relations between the shipyard and the Navy will continue to be poor until the company is paid what it wants or until company officials are convinced that the Navy will pay only what it legally owes. In this regard, you should recognize that the Newport News parent, Tenneco, is not in any financial trouble--the corporation is reporting record profits.

15. Under P.L. 85-804, the Secretary of the Navy has authority to make payments to contractors regardless of contract terms. In this regard, various possibilities have been discussed. For example, it has been suggested that Newport News contracts be reformed to extend contract delivery dates and apply revised escalation provisions on the basis that escalation provisions on current contracts are inadequate. Actually current contracts adequately protect shipbuilders against inflation if the contractors meet contract schedules or if all delays are Government-responsible. Extending contract delivery dates and providing escalation coverage to current Newport News schedules, however, would result in the Government financing contractor-responsible delays.

16. Granting extra-contractual relief in the current circumstances would create problems. Even if Congress were to approve such relief and appropriate the necessary funds, the Navy would be left with the problem of fending off requests from other contractors for similar treatment. It would become increasingly difficult to enforce Government contracts or settle claims on their legal merits.

17. Assuming that the Navy intends to resolve claims on their legal merits rather than grant extra-contractual relief, I recommend the following actions be taken:

a. Make it clear to Newport News and Tenneco management that the Navy will process their claims and settle them based only on the legal merit of the claims.

b. Return responsibility for settling these claims to the Naval Sea Systems Command and discourage company officials from seeking settlements at higher levels.

c. Enforce the Navy requirement that the senior responsible company official certify that the claims are current, complete, and accurate.

d. Provide the Naval Sea Systems Command sufficient resources to review claims expeditiously. Current Navy legal support is inadequate and too much of the burden falls upon technical people, who are becoming increasingly unable to carry out their primary duties because of the claims workload. The Navy needs to hire, or have the Department of Justice hire for the Navy, outside legal counsel and such other assistance as is necessary to assist in the evaluation of claims and claims related matters.

H.G. Rickover

Copy to:
The Secretary of the Navy
The Under Secretary of the Navy
The Chief of Naval Operations
The Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

7 APR 1976

MEMORANDUM FOR CHIEF OF NAVAL MATERIAL

Subj: Shipbuilding claims

Encl: (1) Notes for discussion with Secretary Clements dtd 7 Apr 1976

1. This morning I met with the Deputy Secretary of Defense at his request to discuss the subject of shipbuilding claims.

2. Enclosed is a copy of the memorandum I gave to him.

H. G. Rickover

Copy to:
Chief of Naval Operations
Commander, Naval Sea Systems Command

7 April 1976

Notes for discussion with Secretary Clements

Subj: Shipbuilding claims

1. I understand that you have decided to provide shipbuilders extra-contractual relief under Public Law 85-804 in an effort to improve relations with shipbuilders and dispose of the backlog of shipbuilding claims.

2. I have always advocated strict enforcement of defense contracts and settlement of claims on their legal merits. However, I have also testified to Congress that if senior defense officials decide that claims should be settled on other than their legal merits, they have the authority to provide extra-contractual relief under P.L. 85-804.

3. The application of P.L. 85-804 relief in this area will, of course, create new problems: e.g. how to handle other defense contractors and subcontractors when they request extra-contractual relief; how to get Congressional support for extra-contractual payments to large conglomerates who are reporting high profits; how to negotiate P.L. 85-804 settlements if one contractor demands a profit regardless of circumstances or financial need, and another is willing to absorb a loss; how to determine the form and amount of what is to be given to the contractors in order to get them to drop their claims.

I presume the Shipbuilding Executive Committee which you have appointed to guide and monitor such settlements is considering these problems.

4. I believe that the contemplated, one-time granting of extra-contractual relief will not eliminate the basic problem. In fact, it may be more difficult to conduct future Defense business because contractors may believe the Navy will henceforth ensure their future profitability regardless of their contract performance. Specifically:

a. Shipbuilders may conclude that their present approach of accumulating large backlogs of unpriced changes and alleged constructive changes to serve as a basis for claims is highly effective. Even after they have been given extra-contractual relief on present contracts, when present or future contracts turn out to be less profitable than anticipated, new claims can be expected. One major factor in the Navy's relations with Newport News, for example, has been the company's refusal to pre-price changes or to conduct other day-to-day business in a normal manner. I am not optimistic that paying off all present claims will eliminate this problem in the future. The yards manpower availability problem is still acute. The financial incentive to divert manpower from Navy work to the expanding commercial work will increase if the Navy pays for the delays on Navy work while delays on commercial work are subject to delivery penalties.

b. Since the Navy is presently dependent upon a few private shipyards and the decision has been made not to enforce the present contracts, the Navy will continue to be vulnerable

to shipbuilder assertions that they will not perform Navy shipbuilding contracts unless claims are settled to their satisfaction. For example, Newport News has refused to honor the DLGN 41 contract; announced that it was considering stopping work on the CVN 70 and not entering into new Navy shipbuilding contracts. Such actions underline the Navy's vulnerability to threats of work stoppage, regardless of the legal merits of the shipbuilder's contentions.

c. Navy personnel will still have to devote considerable time and manpower to negotiating and administering fixed priced shipbuilding contracts, trying to pre-price changes, and contesting unwarranted claims--all the while knowing that if the contract overruns, the contractor has a good chance of again getting financial relief by appealing to higher authority.

5. Providing financial relief by reforming escalation clauses on shipbuilding contracts is only a temporary remedy. Although the current claims backlog may be eliminated, similar future problems will not be eliminated. It is not that the escalation clauses on Navy shipbuilding contracts were inequitable. They provided better protection during the period of high inflation than the vast majority of defense contracts which contained no escalation clauses. The only time the Navy's shipbuilding contracts did not protect shipbuilders against the effects of inflation was in cases where delays or increased costs were the responsibility of the contractor. The fundamental problem is that some shipbuilders upon whom we must depend apparently will honor contracts only to the extent they are satisfied with the financial outcome.

92-782 O - 82 - 13

6. For the above reasons, where extra-contractual relief is provided to one or more of the major shipbuilders, I recommend the following:

a. The Government should acquire title to the shipyard as a condition of the P.L. 85-804 settlement. This would ensure adequate facilities for Navy shipbuilding requirements regardless of market demands for commercial ships, and eliminate contractor threats of diverting these resources to other work. In the case of Newport News, special arrangements could be made to complete existing non-defense work. Several shipbuilders have complained that profits are too low on Navy shipbuilding contracts in relation to their investment. They may be willing to liquidate this investment in settlement of their shipbuilding claims. In addition, more members of Congress might support the Public Law 85-804 approach if the Government ends up owning the shipyard.

b. Once title vests in the Government, operate these shipyards as government-owned, contractor-operated plants along the lines the Atomic Energy Commission and its successor, the Energy Research and Development Administration have used successfully for 30 years to operate its facilities and laboratories. Award long term operating contracts, with provisions for replacement of the operating contractor at the Government's discretion. The operating contract should be on a cost reimbursement basis with a sliding fee scale based on volume of work. By providing a guaranteed profit for little or no investment, such an arrangement should make shipbuilding

work financially attractive to contractors. It would enable the contractor and government personnel to devote their entire efforts to the difficult task of building ships, instead of the situation at present where far too much of the time of contractor and Government personnel is engaged in contracting disputes.

6. In the past I have opposed the use of cost-plus contracts for shipbuilding because they tend to destroy contractor incentive to control costs. However, much of the contractor's incentive to control costs under fixed priced contracts is negated when extra-contractual relief is granted. Moreover, it appears we are unable or unwilling to enforce fixed priced contracts with much of the shipbuilding industry. If the Government owns the shipyards; if they are devoted solely to Government work; and if the Government exercises close surveillance I believe that they could be operated at no greater cost to the Government; probably at a lower cost. As a minimum we would eliminate the overhead currently expended in contract disputes between shipbuilders and the Navy. The comparison will, of course, be made with Navy yards. But it must be recognized that these yards have functions which are not performed by private yards. Also, they are bound by Civil Service rules.

7. I continue to advocate strict enforcement of contract terms and settlement of claims on their legal merits. However, on the basis that a decision has been made to grant P.L. 85-804 relief, I recommend that the contemplated extra-contractual settlements with shipbuilders provide for future operation of the shipyards involved on a Government-owned, contractor-operated basis. Under the circumstances this approach offers the best possibility of a permanent solution to the shipbuilding claims problem and has the greatest likelihood of winning Congressional support.

H.G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

22 APR 1976

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Shipbuilding claims

Encl: (1) Notes for discussion with the Honorable Frank A. Shrontz, Assistant Secretary of Defense (I&L)

1. This morning I met with the Assistant Secretary of Defense (Installations and Logistics) at his request to discuss the subject of shipbuilding claims. He was accompanied by the Honorable Richard A. Wiley, Department of Defense General Counsel.

2. Enclosed is a copy of the memorandum I gave to them.

H. G. Rickover

Copy to:
Chief of Naval Operations
Commander, Naval Sea Systems Command
Deputy Commander for Contracts,
Naval Sea Systems Command

22 April 1976

NOTES FOR DISCUSSION WITH THE HONORABLE FRANK A. SHRONTZ, ASSISTANT SECRETARY OF DEFENSE (I&L)

Subj: Shipbuilding Claims

Ref: (a) NAVSEA ltr to Mr. N. W. Freeman, Tenneco, Inc. of 6 August 1975
(b) Memo for Asst SECNAV (I&L) dated 24 March 1976
(c) Notes for discussion with Secretary Clements of 7 April 1976

1. There are currently no outstanding claims against the Navy from Electric Boat Division of General Dynamics. The recent EBDiv claim against the contract for the first flight of follow SSN 688 Class submarines was handled by the Naval Sea Systems Command within the claims handling procedures presently in effect in the Navy. The President of the Electric Boat Division certified the claim in accordance with the requirements of Naval Procurement Directives as being current, accurate, and complete. In the claim release, EBDiv agreed to use their best efforts to submit by 1 December 1976 any remaining claims they may have on the first flight and on the second flight of the SSN 688 Class for events occurring up to 1 November 1976. They agreed that such claims would be certified and would show the cause and effect relationship for which they consider the Government to be responsible under the contracts. Based on this settlement and claim release, and the history of experience in dealing with General Dynamics, there is good reason to believe that the Navy, if allowed to, could work out with EBDiv a reasonable settlement within the terms of the contracts using the Navy's normal claims processing procedures.

2. The major claim currently before the Navy from Ingalls Shipbuilding Division of Litton concerns the LHA's and, therefore, does not involve nuclear ships. The Litton claims concerning nuclear ships have already been reviewed by the Armed Services Board of Contract Appeals and are also under investigation by the Justice Department for possible fraud. The latter matter is currently being investigated before a grand jury in Alexandria, Virginia.

3. The largest unresolved issue concerning shipbuilding claims is how to handle the current Newport News Shipbuilding and Dry Dock Company of Tenneco, Inc. claims. These amount to a requested increase in contract ceiling prices on six contracts which total $894M. If the requested increase of $894M in ceiling prices were granted, Newport News would ultimately receive actual payments of about $443M, if the final costs of the ships are the same as the latest Newport News cost estimates submitted to the Navy. On the other hand, if the $894M increase in ceiling prices were approved, and the final costs of the ships as delivered turned out to be higher than the current Newport News estimates, then in accordance with the cost sharing provisions of the contracts Newport News would receive even more than the $443M. This increase in payments would occur whether or not the increased runout costs were caused by contractor responsible matters, such as slowing down remaining Navy work in order to enable Newport News to meet fixed price commitments on commercial work. If the Newport News claims against the Navy were paid as submitted, Newport News would receive all of their costs for the work they have done and are doing on construction of Navy ships, whether or not these costs were the responsibility of the Government, and would also receive a substantial profit on each contract.

4. There is no question that Newport News in submitting their claims has included in each one some items and some amounts for which the Navy owes them money. For many of these items, the Navy has tried for months, and in some cases years, to get Newport News to submit specific proposals identifying the cost that the Government owes them on the items, so that each could be negotiated on its merits. However, Newport News has reserved these items to include in their omnibus claims so as to ensure that they include at least some items for which there can be no question as to some entitlement.

5. The Navy, of course, must pay Newport News the amounts to which they are entitled by their contracts. The best and quickest way to do this would be for Newport News to submit claims that are factual and correctly relate Government responsible actions to the amount of money the Government owes them. If Newport News would do this, then their claims could be processed fairly and quickly.

6. However, Newport News has chosen to submit voluminous claims which do not relate Government cause to effect and which obfuscate the issues by alleging all sorts of Government actions as being responsible for increased costs, such as Norfolk Naval Shipyard's hiring practices. Newport News refuses to certify their claims as being current, complete, and accurate, and generally claims that the Navy is responsible, and owes them for everything that has happened at Newport News plus a substantial profit. References (a) and (b) discuss this matter in more detail. The result is that the Government is now faced with the basic question of whether the Navy should take responsibility for financial problems at Newport News regardless of the company's responsibility and performance under its Navy shipbuilding contracts.

7. The matter has now, as you are aware, been taken out of the Navy's hands; the Department of Defense has publicly stated that the Navy has handled shipbuilding contracts in an unsatisfactory manner, and that the present contract provisions are inequitable and have resulted in injustices and unfair consequences. In fact, in a pre-trial court hearing this week concerning the dispute over the validity of the option for the CGN 41, Newport News lawyers cited Department of Defense statements that the Navy's contracts are unfair in support of their contention that the CGN 41 option is invalid.

8. When the Department of Defense proceeds with its presentation to the Congress of the need for reforming present shipbuilding contracts under Public Law 85-804, witnesses will, of course, have to substantiate the basis on which the Government finds the present contracts to be invalid. To the extent the Department of Defense succeeds in establishing these points, it could undermine the Navy's position in upholding the validity of the CGN 41 contract option or any other Government contract.

9. Also, there are indications that other contractors are watching this matter with great interest. For example, Curtis Wright Corporation which had withdrawn its request for relief under Public Law 85-804 for nuclear component contracts has now informed their prime contractor, the General Electric Company, that they are reevaluating their position in view of the more liberal approach announced by the Department of Defense concerning the use of Public Law 85-804.

10. Since the use of Public Law 85-804 in the case of Newport News has been initiated by the Government and not the contractor, and is apparently to be applied in order to ensure that the contractor receives profits on present fixed price incentive fee contracts, it is obvious that the entire defense industry will desire to evaluate the impact of the precedents set in light of their own situations. As a minimum, these actions can be expected to encourage defense contractors to handle their contractual dealings at the OSD level rather than at the Navy Systems Command level.

11. As I stated in reference (c), I believe that the contemplated, one-time granting of extra-contractual relief will not eliminate the basic problem. In fact, it may encourage contractors to believe that the Navy will henceforth be instructed to ensure their future profitability regardless of their contract performance. The impact of the use of Public Law 85-804 in this case could be profound on all existing and future Defense contracts.

H. G. Rickover

92-782 (191)

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

APR 2 8 1976

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Shipbuilding claims

Ref:
(a) Navy shipbuilding in the United States; views of Gordon W. Rule, dtd 4 March 1976; reprinted in Congressional Record of 18 March 1976
(b) Navy shipbuilding in the United States; additional views of Gordon W. Rule, dtd 22 March 1976
(c) Gordon W. Rule memo dtd 29 March 1976 to Chief of Naval Material, subj: "The Use of P.L. 85-804 to Remedy the Situation Existing in Three Shipyards in the United States, Which Adversely Affects the Defense of the United States--thoughts concerning"
(d) My memorandum for ASN(I&L) dtd 24 March 1976, subj: Relations with Newport News Shipbuilding and Dry Dock Co.
(e) My memorandum for DEPSECDEF dtd 7 Apr 1976, subj: Shipbuilding claims
(f) My memorandum for ASD(I&L) dtd 22 Apr 1976; subj: Shipbuilding claims
(g) My letter to Mr. N.W. Freeman, Chairman of the Board, Tenneco, Inc., dtd 6 August 1975

1. In references (a), (b), and (c), Mr. Gordon Rule, Director, Procurement Control and Clearance Division, Naval Material Command, has set forth his views concerning Navy shipbuilding in the United States; the shipbuilding claims backlog; the causes of the backlog, and how the claims should be resolved. Mr. Rule attributes most of the current shipbuilding procurement problems to "unfair" Navy shipbuilding contracts which he contends are of the wrong type and which contain delivery dates and target costs that are unrealistic. Mr. Rule's proposed long-range solution to these problems is to eliminate the use of competition in awarding shipbuilding contracts and place these contracts with shipbuilders on a cost-plus basis, definitizing them only as the ships are well into the construction process. References (a), (b), and (c) have been widely circulated to key officials in the Defense Department. The purpose of this memorandum is to point out areas of disagreement between Mr. Rule's contentions and my own views regarding the shipbuilding claims problem.

2. Mr. Rule's memoranda fail to mention the many items of shipbuilder responsibility that have greatly contributed to cost increases; such as, increased overhead, reduced productivity, inadequate manpower, construction errors requiring rework, etc. In the case of Newport News I have cited many such items in references (d) and (g).

3. In regard to Mr. Rule's allegations that the Navy shipbuilding contracts are unfair, it should be recognized that shipbuilders have traditionally enjoyed more favorable contract terms than other defense contractors engaged in fixed priced work. Escalation provisions in shipbuilding contracts are more liberal than those employed in other defense contracts. Progress payment provisions in shipbuilding contracts also are more liberal than those employed in other fixed priced defense contracts. Moreover, the Navy assumes financial responsibility for many of the high risk aspects of ship construction by providing Government-furnished design and components.

4. Type of contract, delivery dates, target costs, shareline provisions, ceiling prices, and other terms and conditions of shipbuilding contracts are, in all cases, mutually agreed to at time of contract award. Contrary to Mr. Rule's statements neither I nor anyone on my staff has attempted to or is able to dictate labor hours or other contract terms to shipbuilders. Mr. Rule should know this since he reviewed each of these contracts before it was placed. In fact he is the only procurement official I know of still in a position of authority who was involved in all of the contracts currently being discussed. For example, in the case of the NIMITZ/EISENHOWER contract which accounts for one-fourth of the total Newport News claims, Mr. Rule personally attended many of the negotiating sessions as well as reviewed and approved the final contract.

5. Mr. Rule cites unfair or wrong escalation provisions as a possible basis for providing shipbuilders extra-contractual relief. There has been misunderstanding and unwarranted criticism of the so-called old escalation provisions used in shipbuilding contracts. Shipbuilders receive escalation protection through several means. Under the escalation clause, they receive escalation payments based on changes in the Bureau of Labor Statistics shipbuilding industry indices. In addition, they often include contingencies in their bids when the anticipate that the impact of inflation will be greater than the amounts that will be paid under the escalation clause. Also, the price of contract changes for extra work

or Government-responsible delay include separate contingencies for escalation. To the extent shipbuilders actually incur more escalation than that covered by the escalation clause or included as a contingency in the contract price, they can recover most of the excess under cost sharing provisions up to the ceiling price of the contract, even if the excess is not due to Government-responsible causes.

6. Under Navy shipbuilding contracts shipbuilders agreed to accept the risk for cost increases beyond ceiling price, including the effects of inflation, unless under the terms of their contracts the responsibility rested with the Government. Thus, shipbuilders were well protected, even through the period of double digit inflation as long as they performed within the contract delivery date and ceiling price. In my view such an arrangement is both fair and equitable. The fact that the Navy subsequently adopted even more liberal escalation provisions in new contracts is primarily due to the shipbuilders superior bargaining position, not to basic inequity in the old escalation clause.

7. Mr. Rule states that although some of the current shipbuilding claims are of dubious value, those that are valid are not settled as promptly as they should be. But the evaluation and settlement of large, multi-million dollar shipbuilding claims is a difficult, time-consuming process, even when they are accurate and complete. More often, however, shipbuilding claims are inflated, and these claims tend to be far more difficult and time-consuming to evaluate, since the Government is forced to investigate every allegation whether founded or unfounded. Moreover, when a shipbuilder elects to prosecute his claim based upon how much money he needs to make his corporate profit or cash flow objectives, rather than what the Government legally owes, negotiations are arduous, time-consuming, and generally unsuccessful.

8. To discourage inflated claims and help speed claims processing, Navy Procurement Directives require that contractors certify at time of claim submission, that their claims are current, complete, and accurate. To date, Newport News has refused to provide the required affidavits. This further delays claim processing.

9. Although Newport News complains about slow handling of shipbuilding claims by the Navy, the company has submitted the bulk of its claims only within the past year. In fact, $665 million of the $894 million backlog of Newport News claims were received since the first of this year. Despite

Navy efforts to negotiate and settle promptly the price of contract changes, and items of alleged Government responsibility at the time the event occurs, the company has refused to do so, electing instead to save these items for use in developing subsequent, omnibus claims such as those recently submitted. Thus, delay in evaluating and settling claims often stems from a shipbuilder's decision to save up individual items for a large, "get-well" claim; the exaggerated nature of the claim; the company's refusal to certify its claim; and its unwillingness to prosecute claims based on their legal merit. The only way to settle such claims promptly is to pay the contractor whatever he wants, regardless of legal entitlement.

10. Mr. Rule points out that there are two sides to every question and that the causes of shipbuilding claims cannot be all the fault of the shipbuilder. To my knowledge, no one in the Navy has suggested that shipbuilding claims are completely without merit. However, from what I have seen, the Navy has been willing to pay what it legally owes. The recent $97 million claim settlement with Electric Boat is a good example. The contractor submitted a claim, and certified that it was current, complete, and accurate. The Navy reviewed the claim and settled it for the amount the Navy determined it legally owed. In claim settlements to date, the Navy seems to have been fair in acknowledging its responsibility.

11. Mr. Rule states that the shipyards involved in the proposed P.L. 85-804 action must realize they have an obligation to cooperate and not expect to obtain benefits beyond what is reasonably determined to be Navy responsibility. However, to determine what the Navy legally owes requires a thorough legal and technical review of the claims. Such a review has not yet been performed. Without such a review by competent legal and technical personnel, neither Mr. Rule nor anyone else can determine how much of what the shipbuilders request is beyond Navy responsibility.

12. Mr. Rule has recommended that in the future the Navy allocate its ship construction contracts to shipyards in accordance with a pre-determined mobilization plan rather than attempt to obtain price competition for combatant warships. He proposes that the Navy then authorize starting ship construction under a cost-no-fee contract to be definitized into a fixed price incentive contract later in the construction period. Mr. Rule's proposed arrangement would eliminate any pressure of price competition in cases where more than one yard can build a ship. Moreover, by routinely authorizing construction before pricing the contract, the Navy would

be deliberately placing itself in a poor negotiating position. Since the amount of profit would presumably be based on the cost, the profit incentive to reduce costs through improved efficiency and productivity would be greatly reduced.

13. Reference (d) presented a summary of my views on the Newport News situation. I made recommendations based on the assumption that the Navy would insist on enforcing its contract terms. In references (e) and (f), I pointed out that the one-time granting of extra-contractual relief is only a temporary remedy; that some shipbuilders upon whom we depend apparently will honor contracts only to the extent they are satisfied with the financial outcome; and that granting P.L. 85-804 relief would create many problems. I recommended that if such a shipbuilder is to be excused from his contracts and given financial relief, the Navy should acquire title to the shipyard as a condition of a P.L. 85-804 settlement, and operate it under cost-plus contract with private industry as a Government-owned, Contractor-operated facility. In that way, the shipbuilder would get his guaranteed profit; the Navy would be assured of adequate shipbuilding facilities, regardless of market demands for commercial ships; and perhaps both contractor and Government personnel could then concentrate their efforts on the difficult task of building ships. The Energy Research and Development Administration and its predecessor, the Atomic Energy Commission, have operated their laboratories and facilities in this manner for 30 years. In this regard, it should be borne in mind that the Government already owns a large amount of the facilities defense contractors operate in manufacturing defense equipment. With Government ownership of the facilities, the operating contractor would still be responsible for efficient performance of the work, but would no longer be in a position to divert the facilities to other work. Further, if the Government were not satisfied with the performance of the operating contractor, the Government could replace the contractor.

14. In summary, Mr. Rule urges excusing shipbuilders from their contract obligations on the basis that alleged poor Navy procurement practices or unfair Navy contracts led to the current claims problem. This ignores the problem that some shipbuilders have been unwilling to settle claims on the basis of legal entitlement. To the extent that these contractors who refuse to honor their contracts are rewarded by extra-contractual payments, other defense contractors maybe encouraged to seek similar relief. Instead of resolving the claims problem, extra-contractual payments could result in an increase in claims throughout the defense industry and development of an attitude among defense procurement personnel that they are to pay whatever contractors request.

15. I would appreciate it if you would distribute this memorandum to those officials who were provided official or unofficial copies of references (a), (b), and (c) so that in their deliberations they can consider the information contained herein.

H. G. Rickover

H.G. RICKOVER

Copy to:
Commander, Naval Sea Systems Command
Deputy Commander for Contracts,
Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

17 MAY 1976

The Honorable Les Aspin
Room 439
Cannon House Office Building
U.S. House of Representatives
Washington, D. C. 20515

Dear Mr. Aspin:

This is in reply to your letter of May 3, 1976. In this letter you stated that you had reviewed my testimony of September 24, 1974 before the Sea Power Subcommittee of the House Armed Services Committee concerning shipbuilding contracts and claims. You requested my comments on the "legality, propriety, wisdom and long-term impact" of the current Defense Department proposal to use Public Law 85-804 to modify certain shipbuilding contracts.

As my testimony shows, I have long advocated enforcement of defense contracts and settlement of claims on their legal merits. I view the issue this way: Why bother negotiating and signing contracts if they are not going to be enforced?

My testimony also shows that if defense officials consider the Navy should settle claims for more than contractors are legally owed, or on any basis which bypasses orderly procedures for settlement of claims, they can exercise their authority to provide extra-contractual relief under the provisions of P.L. 85-804. I have made it clear I fully understand that any settlement made under P.L. 85-804 is a matter within the purview of defense officials and the Congress.

Defense officials have notified Congress of their intention to provide P.L. 85-804 relief to Newport News Shipbuilding and Dry Dock Company, a division of Tenneco; to Electric Boat Division of General Dynamics; to Ingalls Shipbuilding Division of Litton Industries; and to National Steel and Shipbuilding Company. They are doing this to resolve the backlog of shipbuilding claims quickly.

The terms of the P.L. 85-804 settlements with these shipbuilders have not yet been negotiated. Some of the claims have not yet been submitted. The claims in hand have not been reviewed to determine Government responsibility for the amounts claimed. For these reasons, I am in no position to give an opinion on whether the final settlements will

satisfactorily resolve the shipbuilding claims problem. I have pointed out to my superiors that the extent to which the proposed settlements result in the Government paying for items for which contractors are liable may set precedents which could undermine the integrity of Government contracts--not only those in shipbuilding but throughout the defense industry, and possibly other segments of industry as well.

During the past ten years, it has become increasingly common for some shipbuilders who overrun their contracts to submit large, after-the-fact claims in an effort to get the Government to pay for the overrun plus a desired profit. Frequently these claims are exaggerated. Some shipbuilders from the outset of a contract collect a record of every item for which they can find any basis to allege Government responsibility. Years later, when the shipbuilder knows what his final costs will be, these items are consolidated into a general allegation of Government responsibility for all delays and costs experienced, without relating the individual causes to specific effects. The amount claimed is often inflated sufficiently to produce the profit desired by the shipbuilder, even if the claim is settled for only a fraction of the claimed amount.

When such claims are submitted the Navy must perform a rigorous analysis to determine the legal basis for payment. Theoretically the burden of proof rests on the contractor to demonstrate legal entitlement. In practice, the Navy, to demonstrate that the contractor is not entitled to the larger amounts claimed, often ends up having to construct whatever legitimate case the shipbuilder might have. The Navy analysis is obviously time consuming. Sometimes it appears that a shipbuilder saves up these claims to submit to the Navy over a short period, thus creating a large claims backlog. It is not then uncommon for some shipbuilders to pressure defense officials to settle the claims quickly.

Under the terms of Navy shipbuilding contracts, shipbuilders are compensated for changes, disruption, delays and other cost increases, which arise from causes which are the Government's responsibility. The Navy policy is to resolve each item with the shipbuilder as soon as the cause is identified. However, when it becomes evident that the costs attributable to Government-responsible causes are not enough to yield their desired profit, they hold out for higher amounts. They save up items over a period of years which are then submitted as an omnibus claim. They exaggerate the effects of Government actions. They refuse to support the elements with cause and effect analysis. They revise claims repeatedly. They threaten to stop work if the claims are not

paid quickly. They complain publicly and to defense officials about unfair treatment. By these means some shipbuilders believe they will be paid more than if their claims were settled on legal merits.

Some shipbuilders allege in claims that all delays and cost increases are the Government's fault, even when they know that much of the delay and increased cost were caused by factors within the shipbuilder's contractual responsibility. The Navy's normal claims evaluation procedure is to determine and pay only for items of Government responsibility. When agreement cannot be reached the contract calls for referral to the Armed Services Board of Contract Appeals.

The proposed P.L. 85-804 approach would by-pass this process. The decision to apply P.L. 85-804 to shipbuilding claims introduces questions which must be considered by those responsible for implementing this decision. For example:

a. How can the Government determine a fair and equitable settlement without a thorough review and analysis of each claim?

b. How can the need to by-pass normal settlement procedures be justified when shipbuilders themselves have elected to submit large, after-the-fact, "get-well" claims rather than pricing out and settling individual items of Government responsibility as they occur?

c. How can the need for immediate, extra-contractual relief be justified in cases where shipbuilders or their parent conglomerates are reporting record profits?

d. How can P.L. 85-804 relief be granted in the absence of a formal request and documentation as to the need for such relief from the contractors concerned?

e. How can P.L. 85-804 relief be applied without undermining the requirement contained in the Armed Services Procurement Regulations that all other legal or administrative remedies must first be exhausted?

f. How can settlements be reached that do not leave currently pending claims outstanding?

g. How can settlements be reached that do not encourage future claims?

h. How can settlements be reached which will not encourage other Government contractors and subcontractors to seek extra-contractual relief, or not encourage them to adopt the practice of trying to improve their financial position by submitting massive claims?

i. How can the Government have effective business relationships if contractors can conclude the Government will not enforce its contracts?

Statements have been made to the effect that P.L. 85-804 relief is needed because Navy shipbuilding contracts awarded during the late 1960's and early 1970's were inequitable, unfair, or unworkable. The principal reason given is that they allegedly did not protect the contractor adequately against the effects of inflation. The "inequity" stems from the fact that shipbuilding contracts do not protect shipbuilders against the effects of inflation when ships are delivered late or at higher cost for reasons that, under the terms of the contract, are the shipbuilder's responsibility.

When the contracts were negotiated, both the Navy and the shipbuilders were well aware that the contracts did not provide such protection. Moreover, I am aware of no shipbuilder claim which asserts that the escalation clause is inequitable or that the Government is responsible to provide escalation protection for contractor-responsible delays.

The escalation provisions of shipbuilding contracts provide for payments to shipbuilders based on changes in economic indices prepared specifically for the shipbuilding industry by the Department of Labor. Such protection against unanticipated inflation is rarely found in defense contracts outside the shipbuilding industry. Therefore, shipbuilders are better protected from the effects of unanticipated inflation than any other segment of the defense industry. Contractors other than shipbuilders accept the risk of unanticipated inflation on contracts which require many years to complete. In shipbuilding contracts, on the contrary, that risk is taken by the Government to the extent the shipbuilder performs within the negotiated target amounts of the contract.

Shipbuilders suffer from inflation only to the extent their delays or cost overruns are not caused by actions which are the Navy's responsibility under the contract. When the Government is responsible for cost increases beyond the original contract amounts, the contracts provide for reimbursement, including escalation. When the contractor is responsible, the extra costs are his to absorb. That is the identical method used to pay for changes on all other defense contracts.

If the Navy's shipbuilding contracts are determined to be inequitable because they do not protect the shipbuilders from the effects of inflation on contractor-responsible costs, it could then be argued that all long term Government contracts and subcontracts which do not provide such protection are also inequitable.

Apart from whether Congress accepts the characterization of Navy shipbuilding contracts as unfair, inequitable, or unworkable, some shipbuilders may now argue in courts of law that Navy shipbuilding contracts have been impeached by such statements of defense officials before the Congress and are therefore unenforceable. The Navy is already experiencing problems in this regard. Last month in a court pre-trial hearing, Newport News lawyers cited Defense Department statements that Navy contracts are unfair, in support of their contention that the option for the nuclear cruiser CGN-41 is invalid. Thus, should the Defense Department be unable to negotiate a P.L. 85-804 settlement with the shipbuilders, statements made by officials in support of the P.L. 85-804 action might render the contracts unenforceable.

Consequently, if the requested use of P.L. 85-804 is not approved, I believe Congress would be well-advised to establish a formal record as to whether the Navy shipbuilding contracts are, in fact, unfair, inequitable, or unworkable. In this way the statements of defense officials in support of the P.L. 85-804 action will not, of themselves, be sufficient to render Navy shipbuilding and other Government contracts legally unenforceable.

Complaints have been made that the Navy is handling its claims slowly. The impression is left that these delays are causing financial hardship to shipbuilders. In this regard the following status of claims at the four shipyards included in the proposed P.L. 85-804 settlement should be considered:

a. National Steel and Shipbuilding Company. I understand that this company has announced its intention to submit a claim, but to date it has not done so.

b. Electric Boat Division of General Dynamics. One large claim was recently settled for $97 million following normal Navy procedures. Electric Boat currently has no other outstanding shipbuilding claims against the Navy. The company has notified the Navy that a claim on the SSN 688 Class ships will be

submitted later this year. They have agreed that this claim will be certified as current, accurate, and complete as of 1 November 1976; also that the claim will document cause and effect of all Government-responsible items.

c. Ingalls Shipbuilding Division of Litton Industries. The $504.8 million LHA claim is the only Litton claim currently outstanding in the Navy. Although this claim was first asserted in general terms some four years ago, the company did not agree until January, 1976 to submit a documented claim. The Navy is now receiving portions of the claim for evaluation. One $107.8 million shipyard-wide "ripple" claim has been heard by the Armed Services Board of Contract Appeals; the final Board decision is pending. The Board recently issued its decision in the case of a $31.2 million Litton submarine claim, awarding the company $16.5 million. This is the claim before a Federal Grand Jury for investigation of possible fraud.

d. Newport News Shipbuilding and Dry Dock Company, Inc. Of the $894 million increase in ceiling prices requested in the claims submitted, all but $69 million was submitted within the last ten months; $665 million was submitted in the past four months. To date, although so requested by the Navy, company officials have refused to certify these claims as being current, complete, and accurate. Navy Procurement Directives require such certification prior to commencing evaluation.

These claims are voluminous. A cursory review indicates that in many cases these claims do not relate specific causes to specific effects. Extensive Navy effort will be required to determine the amount the Navy actually owes Newport News.

In this regard, if the Navy were to adjust contract ceiling prices by the full $894 million requested, the actual additional Navy cash payments to the company would be about $450 million. This figure is based on the assumption that Newport News will complete the ships within the estimates contained in their latest cost reports. Such a settlement would result in Newport News recovering all their costs plus about twice the aggregate target profits specified in the original contracts. Even if the claims were settled for but

40 percent of the $894 million claimed, Newport News would recover all their costs plus roughly the same aggregate target profit specified in the original contracts.

As discussed below, much of the financial problem on Newport News-Navy shipbuilding contracts is the outgrowth of company actions taken several years ago. Thus, it is apparent that the Newport News claims are highly inflated.

The above status summary shows that, while it does take considerable time to evaluate complex, multi-million dollar claims--particularly when they are inflated and do not reasonably relate cause and effect--the allegation that the Navy has been slow in processing the current claims backlog is misleading.

The basic question in the Newport News situation is whether the Navy will take responsibility for financial problems at Newport News regardless of the company's responsibility and performance under its Navy shipbuilding contracts. In my opinion most of the financial problem on Newport News-Navy shipbuilding contracts is the outgrowth of company actions.

In 1971, Newport News projected a need to build up manpower from 18,200 early in 1971 to over 30,000 employees in 1973 to meet its commitments on existing Navy contracts. In the fall of 1972, Newport News signed a contract for three Liquified Natural Gas Carriers (LNG's) and announced plans to build a new yard for construction of these and other merchant ships. The decision to take these actions was made by Tenneco without any prior consultation or agreement by the Navy--as it was then Newport News' right to do.

At that time, Newport News had an employment level of about 27,000 people and was still building up its manpower. Newport News and Tenneco officials stated at the time that they expected to make manpower for the commercial work available within their expected 30,000 employment level due to a projected decline in Navy work starting in mid-1974.

In early 1973, shipyard productivity decreased and there was a large increase in fabrication errors--apparently caused by the lower skill level of the new hires. In 1973, Newport News announced that it had abandoned its plans to build up to the 30,000 employees which it had projected were necessary to meet commitments on Navy contracts. Since that time the employment level has decreased to the present level of about 22,000.

The decline in productivity and increase in rework during the work force expansion caused an increase in the number of manhours required to complete present Navy contracts. To accommodate this increase in manhours and the shortfall in manning, Newport News stretched out Navy ship construction schedules. Under the contract terms these manpower problems and the costs of escalation on the deferred work are the responsibility of the shipyard.

The shipyard still does not have sufficient trained manpower to meet existing commitments on Navy contracts. As a result, the company is currently faced with: (1) building up the manpower assigned to commercial contracts, (2) delaying the commercial ships, or (3) delaying the Navy ships further. Newport News in its claims states that the Navy is responsible for all the delays and higher costs which accrue on Navy work.

While Newport News is owed some money on its claims, the company, by the nature of its claims submissions, has made it very difficult and time consuming to sort out the items for which legal entitlement does exist. It is reasonable to conclude from the manner in which the claims have been presented that the company believes actual entitlement under these claims to be considerably less than the amount being sought.

Statements have been made to the effect that the shipbuilding claims problem stems principally from the fact that many of these ships are nuclear powered. The type of power plant used in a ship has nothing to do with the issue of whether or not there will be claims. In the early 1970's the large shipbuilding claims involved primarily non-nuclear ships and non-nuclear shipyards, such as Avondale, Todd, and Lockheed; Newport News submitted several claims on non-nuclear ships.

The recent claims by Newport News and Electric Boat involve nuclear ships, since those yards currently build only nuclear ships for the Navy. The Litton claims are only to a smaller extent involved with nuclear ships.

Even in the case of nuclear ships, except for the nuclear propulsion plant--for which I am responsible--the ships are built to the same standards and with the same methods employed on non-nuclear ships. Thus, it is not correct to characterize the shipbuilding claims problem as one predominantly associated with nuclear power.

A specific example may help illustrate what the Navy is up against. Much of the impetus for the decision to settle

shipbuilding claims under P.L. 85-804, in my view, stems from the efforts of Newport News officials and their superiors in Tenneco. About two years ago they began airing complaints about the Navy before Congress and in the press. Company officials took the position that on all Navy shipbuilding contracts they should be guaranteed a 7 percent profit after paying interest and other unallowable costs. To the extent they realize less, they recommended that the Navy adjust its contracts to yield the desired results and modify Navy procurement policies to ensure profitability in future contracts.

Despite Newport News' notification as early as October, 1974 of its intention to submit claims, the company did not submit these until recently--$825 million of the $894 million total in the last ten months, $665 million in the last four months. But the pressure has been intense to settle these claims immediately. On February 19, 1976, Newport News submitted its largest claim on a single contract; a $221 million, sixteen volume claim against the carriers CVN 68 and CVN 69. (Newport News cost reports submitted to the Navy indicate that they have recovered all costs to date on this contract and that, without the claim, Newport News estimates they will make a profit of about $30 million on the CVN 68 and CVN 69.) The following day the President of Newport News sent a letter to the Chief of Naval Operations intimating that Newport News was considering stopping work on the CVN 70 and not entering into new Navy shipbuilding contracts until its claims were resolved.

Six months earlier, Newport News actually stopped work on CGN 41, claiming that the contract option for construction of that ship was invalid. Construction was resumed under court order. However, Newport News still refuses to recognize the validity of the CGN 41 option because they want a higher price. Although the Navy lawyers are convinced that Newport News has no valid legal basis for its contentions, it could take years of litigation to establish that point. In this regard, it is worth noting that the Navy is at a disadvantage in the litigation due to the imbalance in legal resources being applied on this case. The brunt of the Navy's legal work on this case is currently being handled by one lawyer, two years out of law school, who is handling this case as one of several assignments. Newport News, on the other hand, has thus far charged to the Navy contract over $155 thousand of outside counsel fees on the CGN 41 option dispute plus a seven percent profit to Newport News. It is interesting to me that I have been unable to get the Navy to hire outside counsel to help

the Navy prepare its case, but the Navy is paying Newport News for its outside counsel.

Newport News officials have made their intentions clear. On March 15, 1976, the President, Newport News sent a letter to Congressman Downing (reprinted in the March 18 Congressional Record) in which he stated: "I need to bring all the pressure to bear that I can for a prompt and equitable resolution of the differences between the Company and the Navy. Time has run out." Newport News has brought pressure to bear on the Navy through their public statements; by complaints to defense officials and Members of Congress; by threats of taking no future Navy business; and in the case of CGN 41, by challenging the validity of the CGN 41 option and actually stopping work. In my own case, a well-known Washington attorney under retainer to Tenneco, last year lobbied extensively in Congress and in the Executive Branch in an effort to dissuade the Secretary of the Navy from extending me on active duty when my reappointment came up for renewal last January.

There seems to be a tendency by some defense officials to view the shipbuilding claims problem as simply a problem in human relations. In actuality it is strictly one of money. If a shipbuilder is going to hold out for more than he is legally owed, his relations with the Navy will deteriorate until either he convinces the Navy to pay whatever he wants, regardless of legal entitlement; or, until the Navy convinces him he will be paid only what he is legally owed, regardless of pressures the company may bring to bear.

I believe the Navy would be better off if it would insist on compliance with its contracts--in federal court if necessary--to maintain a sound basis for conducting future business. If contractors believe they will be excused from their contract obligations by submitting inflated claims, refusing to honor contracts, complaining to higher authority, and the like, they and others will be encouraged to follow this approach in the future.

I recognize that senior defense officials have responsibilities far broader than my own and as a result may have to view problems differently than I do. Perhaps, because of our dependence on particular private shipbuilders they may be able to refuse to honor contracts. If this is the case, and the Navy is going to have to guarantee profit on shipbuilding contracts under threat of not being able to get Navy ships, I would favor the Government acquiring title to such shipyards. They could then be operated by private industry under long-term contracts that would guarantee the operating contractor

a profit. In that way the Navy would have an assured source of supply; shipbuilding would be financially attractive to contractors (no investment together with a guaranteed profit); and perhaps both the Navy and its shipbuilders could concentrate on ship construction rather than contract disputes. If the contractor did not perform satisfactorily the Navy could seek a different contractor to operate the facility. This approach would prevent the shipbuilder from again forcing reformation of his contracts by threats of diverting his manpower and facilities to other work.

My proposal to acquire certain shipyards and operate them as Government-owned, contractor-operated plants rather than just to reform contracts in response to shipbuilder threats has been criticized as an attempt to nationalize the shipyards, and as being contrary to the "free enterprise" system and defense procurement policies. Actually, the procurement of military hardware from Government-owned, contractor-operated facilities is not a novel method in defense procurement. In fact, it appears that Navy ships are among the few major weapon systems not presently being procured from contractors who use large amounts of Government-owned facilities. Specifically:

a. As of 1975, Department of Defense investment in terms of acquisition cost, in its 88 Government-owned, contractor-operated facilities totaled almost $4 billion. Since most of these plants were built during World War II or the 1950's, the current value of these facilities is undoubtedly significantly greater than the original acquisition costs.

b. The Air Force has 32 major plants which produce and assemble airframes, engines, guided missiles, and electronics for both defense and for commercial customers. The contractors operating these plants rely extensively on Government-owned facilities to perform their contracts. Examples of aircraft weapon systems produced in whole or part at Air Force plants are the B-1 bomber; the F-4, F-15, and F-16 fighters; the F-111 fighter bomber; and the C-5A, C-130, C-140, C-141 cargo planes. Missile systems produced in Air Force plants include the Titan III, Minuteman II and III, SRAM, Genie, TOW, Phoenix, Maverick, and Harpoon.

c. The Navy has 23 active plants dependent on Government-owned facilities to produce and assemble airframes, rocket engines, guided missiles, gun mounts, and electronics. Aircraft weapon systems produced at Navy Government-owned, contractor-operated plants include the F-14 fighter, the A-6E bomber, the EA-6B electronic warfare plane, the E-2C early warning aircraft, the A-7 Corsair II bomber, and the T-2

trainer. Missile systems produced in Navy-owned plants include the Standard and Redeye missile systems, the Condor and Sparrow III missiles, and the Polaris, Poseidon, and Trident I missiles.

d. The Army has 24 ammunition plants which are entirely owned by the Government and operated by contractors. The acquisition value of these ammunition plants exceeds $2 billion. In addition, the Army has 9 other industrial facilities with a total acquisition value greater than $200 million. The Army's M60A1 tanks are built in a Government-owned, contractor-operated facility. Dragon missiles and UH-1 "Huey" helicopters are assembled in Government-owned, contractor-operated facilities.

Except for the Army ammunition plants, most of these facilities are provided under facilities contracts in which the contractor gets rent-free use of the facility for Government work. Many of these plants have Government- and contractor-owned assets intermingled such that the plant cannot be operated properly without the consent and participation of both the Government and the contractor. This co-mingling of assets prevents the Government from changing plant contractors in the event of unsatisfactory management, even if the Government has paid for nearly the whole plant.

Large amounts of the Defense Department's procurement budget are spent on weapons systems produced primarily in Government-owned, contractor-operated facilities. In FY 1976 alone, Congress appropriated:

- $1,036,100,000 for the F-14A fighter, A-6E bomber, EA-6B electronic warfare plane, and the E-2C early warning aircraft--all to be assembled by a contractor at the Navy's plants at Bethpage and Calverton, New York.

- $1,415,500,000 for the F-15 fighter to be produced by a contractor at the Air Force's facility in St. Louis, Missouri.

- $451,100,000 for M60A1 tanks to be built by a contractor in the Army's tank plant in Detroit, Michigan.

- $265,800,000 for Minuteman III missiles which will be built in Air Force facilities and $199,900,000 for the Trident missile which is being developed and is to be produced in a Navy-owned facility.

Thus, if building ships in Government-owned, contractor-operated shipyards is labelled nationalization of an industry and abandonment of the free-enterprise system, then shipbuilding would be one of the last segments of defense industry to be so nationalized. The major difference under the concept I would propose and past Defense Department practice, however, would be that the Government would own the entire shipyard so that the operating contractor could not render the shipyard useless simply by denying use of essential, contractor-owned facilities. The Navy should also retain the right to change operating contractors if they did not perform satisfactorily. This difference would be a major improvement over the manner in which many of our defense procurement dollars are presently spent.

I trust this letter is responsive to your request. In view of the fact that the general problem of Navy shipbuilding claims is presently the subject of public hearings by the House Armed Services Committee, I have taken the liberty of providing a copy of my response to the Chairman of that Committee.

Respectfully,

H. G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

2 June 1976

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Letter to you from J. P. Diesel, President, Newport News Shipbuilding and Dry Dock Company of 21 May 1976

With the subject letter, a copy of which you furnished me on 27 May 1976, Mr. Diesel forwarded to you a 16-page "Analysis of Memoranda Signed by Admiral Rickover." Mr. Diesel's "analysis" lists Newport News comments on my 24 March 1976 memorandum to the Assistant Secretary of the Navy (Installations and Logistics) concerning Navy relations with the Newport News Shipbuilding and Dry Dock Company. It also lists comments on my 28 April 1976 memorandum to you concerning statements recently made by Mr. Gordon W. Rule about shipbuilding claims. I understand that you did not furnish my memoranda to Mr. Diesel or ask for his comments on them.

I believe you already have sufficient information to recognize that Mr. Diesel's "analysis" contains many incorrect, misleading, and incomplete statements. Therefore, I see no need to prepare a detailed rebuttal pointing out the many errors and incorrect allegations made therein. However, there are some points I would like to emphasize.

First, I find nothing in Mr. Diesel's "analysis" that nullifies the validity of the statements in my memoranda, except that Mr. Diesel is correct that Newport News has not submitted a claim to "cover every active Navy shipbuilding contract at the shipyard." As he points out, no claim has been submitted on the SSN 688 Class submarine contract which was placed only 10 months ago.

Second, Mr. Diesel's discussion of the availability of manpower at Newport News is not in accordance with the facts. His discussion also appears to be an attempt to blame the Navy incorrectly for impending delays on commercial new construction. I am attaching herewith a copy of a 10 October 1972 letter to me from Mr. L. C. Ackerman, who at that time was Chairman of the Board and Chief Executive Officer of

Newport News. Mr. Ackerman's letter confirmed that as late as October 1972, Newport News expected to build up their work force to a level of 30,000 people to meet their commitments on Navy contracts. When they were unable to do so, the schedules on Navy ships were inevitably delayed.

Attached also is a copy of a 19 May 1976 report from the Supervisor of Shipbuilding, Newport News, indicating that scarce manpower is being diverted to commercial construction work at Newport News to the detriment of Navy work. Contrary to the impression conveyed in Mr. Diesel's "analysis," these documents show that the current delays on Navy ships have been caused to a significant extent by the inability of Newport News to hire and train the skilled manpower Newport News needed to meet its commitments on Navy contracts, and that Newport News is now in the process of increasing manpower on commercial work while decreasing manpower on Navy work.

I recommend that you take action to obtain priorities assistance from the Department of Commerce to ensure that Newport News does not allow Navy work to be delayed by commercial work.

Third, Mr. Diesel puts the Navy on notice of a possible future claim against the Navy for cost overruns on their commercial work. He states:

> "There now exists the strong possibility of the delayed Navy contracts interfering substantially with other legitimate commercial obligations of the Company.
>
> "Furthermore, the extra work and delays caused by the Government greatly compound the Company's difficulties in performing its own responsibilities."

He also notifies you that Newport News considers the Navy to be in breach of its contracts, as follows:

> "The Company believes the overall actions of the Navy constitute a substantive breach of all its contracts with the Company."

I recommend that you request Navy lawyers to study the statements made by Mr. Diesel concerning the above matters to determine what action should be taken to protect the Navy in the face of such formal notifications.

Fourth, Mr. Diesel does not factually describe the actual nature of Newport News claims when he states:

> "The Company does not allege that the Government is responsible for all increased costs and delays. To the contrary, it concedes that substantial problems may be contractually the responsibility of Newport News."

While the Company may concede that substantial problems may be the responsibility of Newport News, the Company is asking the Navy to pick up the tab for all the problems. The fact is that if the Government accepted the Newport News claims for overall ceiling price adjustments of $894 million on six shipbuilding contracts, Newport News would thereby receive payment for all of their presently projected costs, plus an aggregate profit about twice the target profit originally included in the contracts involved.

Fifth, contrary to the implication in Mr. Diesel's letter, I have never suggested that the Government acquire a shipyard without paying for it. I have pointed out that because of the Navy's dependence on particular private shipbuilders, the latter may be able to refuse to honor contracts. I explained that if this is the case, and the Navy is to be required to guarantee profit on shipbuilding contracts under threat of not being able to get Navy ships, the Navy should acquire such shipyards to be operated as Government-owned, contractor-operated plants.

In this regard, it is my understanding from a prior discussion with Admiral Kidd, your predecessor, that in a meeting with Mr. N. W. Freeman, then Chairman of the Board of Tenneco, Mr. Diesel, and Mr. Corcoran on 4 February 1975, Mr. Freeman spoke to the effect that Tenneco had concluded that "Newport News was not their cup of tea" and that Tenneco would "like to find a buyer for the shipyard." You may desire to review the record Admiral Kidd made of this meeting.

Sixth, Mr. Diesel's "analysis" includes many incorrect allegations concerning actions by members of my organization. The intent of these allegations appears to be an attempt to obfuscate the issue of what amount the Navy actually owes Newport News on its claims; this is done by alleging impropriety on the part of individuals and organizations in the Navy. For at least the past two years, Tenneco and Newport News have increasingly followed this approach toward resolution of their financial difficulties.

Seventh, I have continually urged that the Newport News claims be handled through the claims evaluation process. In that way, the merits of Mr. Diesel's charges could be evaluated by the appropriate legal and contractual personnel in accordance with established legal procedures. In that manner the merits of Mr. Diesel's claims and charges can be established, and Newport News can be paid what is legally owed. However, if these claims are to be settled by granting extra-contractual relief, I continue to believe that the best solution would be for the Government to obtain title to each shipyard so relieved.

H. G. Rickover

Copy to:
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

09 JUL 1976

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Hiring Outside Legal Counsel

Ref: (a) My May 17, 1976 ltr to Congressman Aspin
(b) Navy General Counsel memo to CNM dtd 27 May 1976
(c) Navy General Counsel ltr to Chief Counsel, Senate Armed Services Committee dtd 4 June 1976

1. In reference (a), I responded to Congressman Aspin's request for my comments regarding the shipbuilding claims problem. In that letter I mentioned the need to hire outside legal counsel to assist in the evaluation and processing of these claims; something I have recommended consistently for over five years.

2. In references (b) and (c) the Navy General Counsel, Mr. E. Grey Lewis, commented on my letter to Congressman Aspin. He states that he does not favor hiring outside legal counsel. Mr. Lewis denies that there is an imbalance in legal resources being applied by the Navy and Newport News currently in the CGN 41 option litigation. He challenges my statement that Newport News "has thus far charged to the Navy contract over $155 thousand of outside legal fees on the CGN 41 option dispute..." He also alleges that my recommendation to hire outside counsel is based on sinister motives. The purpose of this memorandum is to set the record straight in regard to Mr. Lewis' comments and to solicit your continued support in efforts to obtain outside legal counsel to assist in evaluating shipbuilding claims. This would facilitate the accelerated processing of shipbuilding claims by the Navy which, I believe, would be in accordance with Secretary Clements' wishes.

3. Mr. Lewis denies that there is an imbalance of legal resources being applied in the CGN 41 litigation. However, I believe the contractor is better staffed for this job than the Navy, through no fault of the Navy attorneys actually handling the case. In addition to in-house counsel, Newport News has at least five private law firms working on its shipbuilding claims problems. Newport News and its parent, Tenneco, are represented by nationally prominent attorneys with years of experience. For example, the former deputy assistant to President Eisenhower was one of the attorneys representing

Newport News in court on the CGN 41 case. Mr. Thomas G. Corcoran is another well-known attorney representing the company. Another firm , headed by a former member of the Armed Services Board of Contract Appeals, two years ago hired the former Naval Sea Systems Command Deputy Counsel for Claims. A member of this firm recently stated they are representing shipbuilders including Litton and Newport News and the similarity of legal arguments being used by these two companies would seem to confirm this. While all five outside law firms may not be directly involved in the CGN 41 case, they are all involved to some extent in the Newport News claims problem, of which the CGN 41 case is a part.

4. As I pointed out in reference (a), one attorney two years out of law school, was bearing the brunt of the Navy's legal work for the CGN 41 case at the time I wrote Congressman Aspin. Moreover this was not his sole assignment. The Navy General Counsel is correct in pointing out that other Navy attorneys have been involved in this case at times. For example, when the Navy was forced to go to court by Newport News stopping work on the CGN 41, and when the Navy had to submit its position regarding availability of funds to the General Accounting Office, there was a short term infusion of additional Navy legal effort. To meet such crises, legal resources have to be siphoned from other projects to the detriment of those projects. Much of the work and direction then tends to be taken over by attorneys who have not been involved in the case on a continuing basis and who may not be sufficiently familiar with the background facts and details necessary to prepare the best case for the Navy. The two senior Navy attorneys who were most familiar with the CGN 41 matter, Mr. John J. Phelan, Jr., former Deputy General Counsel for the Navy, and Mr. David W. James, Jr., former NAVSEA Counsel, have subsequently left the Navy.

5. As priorities change, legal resources are diverted from one crisis to another. As a consequence, on individual cases, Navy technical personnel often must be relied upon to provide continuity. Frequently they have to take the lead in developing strategy, organizing and directing the claim analysis, preparing and answering interrogatories, drafting correspondence and so on -- actions which properly are the functions of the legal staff. On several occasions, I have had the opportunity to observe the performance of private law firms in cases where prime contractors are defending the Government's interest in lawsuits by subcontractors. My experience has been that private law firms actually take the initiative and relieve the technical personnel of the burden of preparing for litigation to a far greater degree than do Navy lawyers.

6. The second statement in reference (a) which Mr. Lewis challenged, reads: "Newport News... has thus far charged to the Navy contract over $155 thousand of outside counsel fees on the CGN 41 option dispute plus a seven percent profit to Newport News." Mr. Lewis states: "Newport News has only attempted to charge these fees; they have not been allowed by the DCAA auditors, and the fees will almost certainly be disallowed."

7. I do not understand why Mr. Lewis disputes my statement. The Defense Contract Audit Agency (DCAA) has reported that Navy payments to Newport News through 13 May 1976 included $154,272 for account D.3406-0027, and there is also a 7% profit on that amount. All except $6,275 of this amount, identified as "Other", was paid by Newport News to three law firms -- Hamel, Park, McCabe & Saunders; Sullivan, Beauregard & Clarkson; and Ferguson & Mason. Not until nearly a month after my letter to Congressman Aspin, were these payments suspended by DCAA and deducted from other payments due. Therefore, contrary to the impression left by Mr. Lewis' letter, my statement was correct.

8. In reference (c), Mr. Lewis states:

> "The truth of the matter is that there is no need to hire outside counsel. I believe what is really involved is the desire of Admiral Rickover to obtain his own law firm which he can then use against Newport News or any other corporation or person he chooses, or even against legal positions taken by my Office or the General Counsel for the Department of Defense"

Mr. Lewis' characterization of my motives for recommending outside counsel is wrong, as he should well know from the record of correspondence on this matter over the past 5 years. The record is clear that I have recommended that the Navy hire outside counsel to help with claims in order to better defend the Government's interests and to lighten the load these claims place on the Navy. Two years ago, Mr. Lewis himself agreed to adopt this recommendation on a trial basis for certain claims at Newport News. His lawyers drafted, and he approved, a proposed contract for outside counsel. This contract would have placed direction and control of the work under Mr. Lewis's organization, not mine. I agreed that outside counsel should work for the Navy lawyers. Never have I suggested that outside counsel should work for me or my organization. Accordingly there is no basis for Mr. Lewis's allegation that I have been seeking to obtain my own law firm.

9. As you may recall, the contract for outside counsel was never awarded. A brief chronology follows:

- In August 1974 Mr. Lewis agreed to the hiring of

outside counsel to help with the shipbuilding claims and instructed Counsel, Naval Sea Systems Command (NAVSEA) to proceed.

- By memorandum dated 21 October 1974 to the General Counsel, Department of Defense, Mr. Lewis set forth his plans to hire outside legal services. He stated that he had discussed the matter with the Deputy Assistant Attorney General and concluded that hiring outside counsel would be lawful. He submitted a list of 16 law firms that he considered qualified for this work.

- On December 4, 1974, Congressman Charles E. Bennett of the House Armed Services Committee wrote you supporting the hiring of outside counsel and inquiring if and when the Navy intended to do so.

- By letter dated January 10, 1975, you replied to Congressman Bennett that "The Navy intends to adopt the proposal on an experimental basis ... subject to approval of the Department of Justice."

- By letter of January 15, 1975, you again assured Congressman Bennett the Navy intended to hire outside counsel on an experimental basis and for a limited purpose subject to approval of the Department of Justice.

- On 20 January 1975, the General Counsel of the Department of Defense wrote the Acting Attorney General seeking his advice in interpreting certain statutes and requesting his opinion concerning the Navy's authority to take the proposed action.

- On 26 March 1975, the Justice Department reversed its previous position and ruled that the Navy could not hire outside counsel.

To my knowledge, the Navy made no attempt to reclama the Department of Justice ruling. Mr. Lewis subsequently reversed his position and now opposes the hiring of outside counsel.

10. The final item of Mr. Lewis' memorandum on which I wish to comment reads:

> "Admiral Rickover and his assistant, David Leighton have told me and former Under Secretary David Potter the major reason for seeking outside counsel is their desire to obtain the services of an attorney with a national reputation (the name William Rogers was

mentioned) to show Newport News that the Navy meant business and to lobby in Congress. We assumed that he wanted a person to counter Tenneco's Thomas G. Corcoran. Lobbying by the Executive Branch is prohibited by statute and I will have nothing to do with it."

It is true that both Mr. Leighton and I, on various occasions, strongly recommended that the Navy retain the services of a top-flight, well-established law firm, knowledgeable of the intricacies of Government. Contractors hire such firms to help them prepare and prosecute their claims. The Corcoran firm is but one example. My point is that the Navy should hire firms of comparable qualifications and experience to defend its interests. I have not -- and Mr. Leighton assures me that he has not -- ever advocated that the Navy hire an outside law firm to "lobby in Congress" or engage in any other activity which is prohibited by statute. In regard to the CGN 41, we both supported the recommendation of Rear Admiral S.J. Evans, who was then Deputy Chief of Naval Material (Procurement & Production) and head of the Navy's CGN 41 negotiating team, that the Navy hire a firm that could bring to bear, on a full time basis, talent comparable to that of the attorneys representing Newport News. It was specifically pointed out that Newport News was well represented by Mr. Gerald D. Morgan. I am sure that you will recall that Mr. Morgan, who died recently, had a long and distinguished career including that of assistant legislative counsel for the House of Representatives and deputy assistant to President Eisenhower. Admiral Evans cited the firm of William Rogers as an example of the type of firm the Navy should consider and Mr. Leighton and I agreed that that firm should be one of those considered.

11. Mr. Lewis comments that "There is no need to hire outside counsel." Yet the situation today seems to be worse than it was when he previously concluded his staff was saturated and needed assistance from outside counsel. Specifically:

- o In September 1974, one month after Mr. Lewis agreed that he should obtain outside counsel to assist with shipbuilding claims, NAVSEA reported outstanding claims totaling $1128.1 million. (This figure includes Armed Services Board of Contract Appeals cases, as well as claims in NAVSEA.)

- o The latest NAVSEA report indicates claims totaling $2032.5 million as of March 1976. Since then the Electric Boat Division claim of $200 million was settled.

- o In October 1974, Mr. Lewis made the following statements concerning the workload imposed on the Navy

legal staff by claims:

"Within the past few years the filing of massive claims arising out of the Navy's contracts has strained the ability of the various Command Counsel not only to provide the normal day-to-day legal services but also to investigate, analyze, and marshal the Navy's defense against these large claims. This strain was most noticeable in the late 1960's and early 1970's when the massive shipbuilding claims began to accumulate. This strain was substantially relieved by the 1973 augmentation of the NAVSHIPS legal staff with additional attorneys both in Washington and at field activities devoted solely to the analysis of massive claims. At some point, however, even the augmented Office of Counsel for the Naval Sea Systems Command reached a saturation point. That is, the number and complexity of existing claims now exceed the time of the available attorneys to devote to handling such claims." (underscoring added)

He also wrote:

"Regarding the existing ceiling on the number of claims attorneys, Counsel has been advised that although the 39-billet ceiling for NAVSEA Office of Counsel is not to be diminished in Fiscal Year 1975, it most prorbaly will be cut in Fiscal Year 1976, and most certainly will not be augmented further."

- Today the NAVSEA legal staff is 42, an increase of less than 10%. However, the dollar amount of the claims backlog is over 50% greater than it was in the fall of 1974.

- Of perhaps greater significance to the NAVSEA situation, the "active claims" being handled by its legal staff (that is, eliminating the ASBCA cases which are handled primarily by the Contract Appeals Division lawyers rather than NAVSEA lawyers) has grown from $421.3 million in September 1974 to about $1500 million at present.

- Newport News has threatened work stoppages and legal actions against the Navy. Litton has also threatened to stop work if their shipbuilding claims are not resolved promptly. In addition, Litton recently filed suit against the Navy in Federal Court.

- The Navy has been directed to accelerate its claims settlement efforts for its shipbuilding claims.

12. From the above, it is apparent that the claims load on

the Navy has grown substantially since the time that Mr. Lewis, himself, concluded that Office of Counsel, NAVSEA had "reached a saturation point."

13. Government lawyers traditionally have opposed hiring outside law firms on the basis that the Government lawyers do an adequate job; that they are less expensive than private law firms; that hiring outside counsel would demoralize Government lawyers because they may be paid less than their counterparts in private practice; and that hiring of outside counsel would imply that Government lawyers are not capable. These are not valid arguments.

14. A decision to get outside help need not entail the abolition of an in-house capability. For example, I have developed a strong in-house technical capability for design of naval nuclear propulsion plants. However, I would never have Government engineers try to perform all the design, engineering and manufacturing work for these plants. The job is too big. Therefore, most of that work is performed by contractors under the close technical direction and surveillance of my staff. The fact that the cost, including overhead and profit, for a manhour of work by a contractor engineer exceeds the hourly wage of a Government engineer is not the determining factor in deciding who should do the work. I do not believe the people in my organization feel slighted when the Navy contracts with private firms for the work which they supervise even in cases where the contractor employee is better paid. They recognize that the contractors can help them get their jobs done. In like manner, I believe the Navy could benefit greatly if its Office of General Counsel would take advantage of outside counsel to assist in the processing of claims.

15. Based on the above, I strongly recommend that you initiate action through the Department of Justice, or through other appropriate channels, to arrange for the Navy to obtain assistance from outside counsel.

H.G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Operations
Chief of Naval Material
General Counsel, Department of the Navy
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

24 August 1976

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: CGN 41 Option Negotiations with Newport News

1. As I stated in my telephone call late yesterday afternoon, I have been hearing persistent rumors since last Friday that Mr. Gordon W. Rule has made an agreement with officials of Newport News to settle the CGN 41 option dispute. Prior to my call to you, the Commander, Naval Sea Systems Command told me that he had also heard rumors of an agreement but knew nothing more. The terms of the purported "handshake" agreement are so unfavorable to the Navy that I telephoned you to determine whether an agreement had been made. You assured me that no agreement had been made. In a subsequent telephone conversation, the Vice Chief of Naval Material also confirmed that no CGN 41 settlement has been made.

2. According to the rumors I had heard, in a meeting in Naval Material Command Headquarters on 20 August 1976 with senior Newport News officials, Mr. Rule agreed to settle the CGN 41 option dispute on the following basis:

a. Reform the escalation article now in the contract for CGN 41 to eliminate escalation tables and to substitute the escalation language of the SSN 711-715 contract for the escalation language now in the contract for the CGN 41. The escalation index would be capped at August 1980, but payments would continue until completion of the contract. This contract reformation would have the effect of accepting as government responsibility all delays in the CGN 41 from the present contract delivery date of October 1978 to a date six months beyond the current Newport News scheduled delivery date of February 1980. In this regard it should be borne in mind that the record, as documented in the letter dated 13 May 1976 from the Navy's CGN 41 Negotiator to Newport News, clearly shows that the government is not responsible for the delay of CGN 41 beyond the present contract delivery date of October 1978.

b. Reform the CGN 41 contract to provide for payment outside of the basic contract ceiling price for employee fringe benefits. Since payment for employee fringe benefits is already included in the original contract ceiling price, this contract reformation would seem to give Newport News a windfall.

c. Reform the CGN 41 contract to provide for payment outside the basic contract ceiling price for increased energy costs. Since payment for energy costs is already included in the original contract ceiling price, this contract reformation would also seem to give Newport News a windfall.

d. In return for the contract reformations discussed above, Newport News would give the Navy a claims release on CGN 41 as of the settlement date. Since very little work has been done on the CGN 41 by Newport News to date, the value to the government of such a claims release is negligible.

3. I appreciate fully the desirability and difficulty of achieving a negotiated settlement of the CGN 41 dispute with Newport News within the contract terms. However, to my knowledge, Newport News has refused to negotiate on this basis.

4. Prior to the appointment of Mr. Rule as the Navy Negotiator, two separate Navy negotiating teams, including technical personnel and counsel, were appointed to negotiate CGN 41 matters with Newport News. These teams explored in depth the numerous allegations made by Newport News as the basis for requesting new contract agreements. They found the Newport News position to be essentially without merit. Navy counsel agreed. The Comptroller General has also reviewed many of the Newport News allegations and has issued a decision in the Navy's favor. The records of these negotiations and reviews are available.

5. In my opinion, the rumored agreement, if implemented, would show that the Government will not require Newport News to honor its contracts. This precedent would encourage other defense contractors who want to reform their contracts to follow the approach taken by Newport News in this matter. Such a settlement would result in the taxpayers incurring costs which are not their responsibility. To modify the contract without adequate consideration, short of a proper court determination, could compromise the government contract system.

6. In view of the above, I consider that any proposed settlement should be carefully reviewed to ensure that it is consistent with the terms of the CGN 41 contract, unless the provisions of P. L. 85-804 are invoked. Accordingly, I recommend that, prior to approval, any proposed CGN 41

settlement be referred formally to the Naval Sea Systems Command for review and comment by knowledgeable personnel directly responsible for the work in question. In this regard I will be glad to provide assistance based on my own knowledge of the events in question.

H. G. Rickover

Copy to:
Secretary of the Navy
Assistant Secretary of the Navy
(Installations & Logistics)
Navy General Counsel
Chief of Naval Operations
Vice Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C 20360

MAT 00:FHM:py
00 Memo 551-76
26 August 1976

MEMORANDUM FOR ADMIRAL H. G. RICKOVER

Subj: CGN-41 Negotiations with Newport News Shipbuilding and Dry Dock Company

Ref: (a) ADM Rickover Memo for CNM of 24 Aug 1976
(b) ASN (I&L) Memo for CNM of 16 Jul 1976, same subj.
(c) ADM Rickover Memo for CNM of 21 Jul 1976

1. Your memorandum of 24 August 1976 offered several points for consideration during the current negotiations between the Navy and Newport News regarding the CGN-41 contract dispute. These, as well as other contract issues are being carefully considered.

2. Please be assured that any discussions concerning the nuclear propulsion plant of CGN-41 will promptly be brought to the attention of you and your staff. I plan to stay in close contact with the Commander, Naval Sea Systems Command concerning the progress of the CGN-41 negotiations.

3. As you know, reference (b) provided negotiating authority for the CGN-41 contract to Mr. Gordon Rule. This responsibility was clearly acknowledged by reference (c). From your many years in government service I know you realize that business sensitive negotiations should not be influenced by sources outside of the designated negotiating parties, and that a broadly distributed letter from you, such as reference (a), cannot help but cause pertubation in the negotiating process, disrupting the efforts of the assigned negotiator.

4. For reasons such as this, you must stand apart from these negotiations unless the technical areas regarding naval nuclear reactors become involved.

F. H. Michaelis

Copy to:
SECNAV
CNO

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

27 August 1976

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: CGN 41 Negotiations with Newport News

Ref: (a) My memo to you of 24 Aug 76; Subj: CGN 41 Option Negotiations with Newport News
(b) Your memo to me of 26 Aug 76; Subj: CGN 41 Negotiations with Newport News Shipbuilding and Dry Dock Company
(c) My memo to you of 28 Apr 76; Subj: Shipbuilding Claims

Encl: (1) Memorandum of 12 Aug 76 telephone call between Mr. D. T. Leighton of my staff and Mr. G. W. Rule concerning CGN 41
(2) NAVSEA ltr 1820 of 22 Jul 76 to Director, Procurement Control and Clearance Division

1. In reference (a), I reported rumors to the effect that Mr. Gordon W. Rule had made an agreement with officials at Newport News to settle the CGN 41 option dispute. Prior discussions I had with you, the Vice Chief of Naval Material and the Commander Naval Sea Systems Command indicated that no agreement had been made. Because the rumored agreement, if implemented, could undermine the enforceability of Government contracts, I reported these rumors to you. I recommended that prior to approval, any proposed CGN 41 settlement be referred formally to the Naval Sea Systems Command for review and comment by knowledgeable personnel directly responsible for the work in question.

2. In reference (b) you stated that the points I raised, as well as other contract issues, are being carefully considered; that any discussions concerning the nuclear propulsion plant of the CGN 41 will be promptly brought to my attention; that you plan to stay in close contact with the Commander Naval Sea Systems Command concerning the progress of the CGN 41 negotiations. Reference (b) also stated that Mr. Rule has been assigned negotiating authority for CGN 41; that business-sensitive negotiations should not be influenced by sources outside the designated negotiating parties; and that a broadly distributed letter from me, such as reference (a), cannot help but cause perturbation in the negotiating process,

disrupting the effort of the assigned negotiator. In conclusion, reference (b) states "For reasons such as this, you must stand apart from these negotiations unless the technical areas regarding naval nuclear reactors become involved."

3. I have not been involved in the CGN 41 negotiations subsequent to 14 July 1976 when I received the directive issued by the Assistant Secretary of the Navy (Installations and Logistics) abolishing the CGN 41 Steering Group to which I was appointed a member by the Under Secretary of the Navy. I have had no discussions regarding the CGN 41 negotiations with Newport News or with the Navy negotiator, Mr. Rule. Nor have I been consulted by Mr. Rule. At one point he did contact Mr. Leighton of my staff. Enclosure (1) is a memorandum record of that discussion as confirmed by Mr. Rule. My staff assisted in the preparation of enclosure (2) which the Naval Sea Systems Command Director of Contracts submitted at Mr. Rule's request. Enclosure (2) identifies issues raised by Newport News and the Navy position that had been taken up to the time of Mr. Rule's assignment as CGN 41 negotiator. Neither enclosure (1) nor enclosure (2) are improper efforts to influence the CGN 41 negotiator.

4. As to your concern regarding the distribution of reference (a), I sent copies to those senior Navy officials who have responsibilities regarding the CGN 41. Since my telephone discussions cited in reference (a) indicated that the cognizant Navy officials may not have been aware of the rumored agreement, I felt obliged to inform them of what I had heard. I am sure you are not implying that it is improper for me to call such matters to the attention of those responsible, and point out potential problems. To remain silent would be analogous to not warning my mother that she was about to fall off a cliff.

5. In reviewing the list of officials to whom I sent reference (a), I do not recognize any who should not be fully informed and approve of any agreement before it is made. As to my own involvement, you must recognize that whatever agreement is finally reached, it may have an impact on my ability to carry out my responsibilities for this nuclear powered warship. It was for this very reason that my organization has participated in the development of the contract for every nuclear warship, starting with the NAUTILUS. In fact, the present negotiations on the CGN 41 are the first concerning a nuclear warship in which I have not been consulted. Also, they are the first shipbuilding negotiations of which I am aware that the technical personnel responsible for the non-nuclear portions of the ship and Navy lawyers have not been consulted and represented on the negotiating team.

6. As I understand Mr. Rule's charter, he is the CGN 41 Negotiator, not the final decision maker. In the course of his duties, I presume that he is subject to the applicable procurement laws and regulations, and that his proposed actions are subject to the reviews and approvals required in the case of other Navy procurements. Therefore, I do not see how my alerting cognizant Navy officials to potential problems with the CGN 41 settlement, of which they appeared to be unaware, could constitute an improper attempt to influence business-sensitive negotiations. Moreover, if in fact an agreement was reached on 20 August, as Newport News contends in its 25 August press release, my memorandum of 24 August could not possibly have perturbed the negotiating process. Further, the rumored agreement was known at lower echelons before I wrote my memorandum. I therefore considered that the responsible officials should be informed at once, particularly since they indicated to me that no settlement had been reached.

7. Reference (b) implies that CGN 41 settlement negotiations do not involve the nuclear propulsion plant of CGN 41. However, the rumored settlement, if implemented, would have a definite impact on matters under my cognizance. In arguing that the CGN 41 contract is invalid, Newport News denies responsibility for late ordering of contractor-furnished nuclear propulsion plant material and contends that changes in Government-furnished plant drawings, including reactor plant drawings, invalidates the CGN 41 contract. Further, Newport News has made specific allegations concerning actions by my organization to support their contention that the CGN 41 option is invalid.

8. Navy analysis and detailed negotiations prior to the assignment of Mr. Rule as CGN 41 negotiator concluded that these arguments were without merit and that there was no legal basis under the terms of the contract to extend the contract delivery date and provide escalation coverage for the extended deliveries as Newport News has requested. The rumored agreement, however, would extend the contract delivery date for almost two years beyond the current contract delivery date. Barring information not previously considered by the Navy, such an extension of the contract delivery date, with the Government paying escalation costs for the delay, would indicate that the Navy had abandoned its resolve to enforce the CGN 41 contract.

9. Were the rumored settlement implemented, the Navy would accept responsibility for the delay in construction of the nuclear propulsion plant in the CGN 41. As you know, Newport News has been trying to get the Navy to extend contract delivery dates on nearly all its ships, so as to make manpower available for their commercial work, while at the same time getting the Navy to pay for the cost of the resultant delays on Navy

contracts. Moreover, if Newport News or other contractors believe the Navy will not enforce its contracts, the basis of technical control over the design and construction of nuclear propulsion plants could be jeopardized, since I must depend on the enforceability of Government contracts to exert the necessary technical controls over this work.

10. Thus, the rumored settlement would definitely affect matters under my technical cognizance, as well as those of other technical managers. I will continue to inform you, to the best of my ability, of the possible implications and ramifications of any CGN 41 settlement terms being considered by the Navy. I am, of course, hampered in this regard when information concerning the proposed settlement is deliberately withheld from me.

11. If the rumor reported in my 24 August letter is correct—and the Newport News press release of 25 August seems to confirm it—I believe you should be grateful that I gave you important information which apparently you did not have. In this connection, several additional rumors are being circulated about the purported CGN 41 settlement which you and other responsible officials should be aware of. If these rumors are true, they indicate an apparent abandonment of Navy procurement procedures, as well as Government rights in the CGN 41 dispute. Other contract disputes could also be jeopardized. The damage to the Navy's procurement organization could be considerable.

The rumors are:

- Mr. Rule and Newport News representatives reached a "handshake" agreement on 20 August 1976 apparently along the terms I outlined in reference (a).

- The Newport News General Counsel was present but no Navy lawyers were present.

- The terms of the agreement were not cleared nor reviewed in advance with the Navy lawyers or with knowledgeable personnel in the Naval Sea Systems Command.

- Allegedly the agreement was not documented and the cost to the Navy of the agreement was not identified before the agreement was made. Allegedly Newport News has subsequently drafted or is drafting a contract modification to implement this agreement. Receipt by the Navy of this Newport News drafted contract modification will be necessary before the actual cost of the agreement can be calculated by the Navy.

- Allegedly the Justice Department attorney handling the CGN 41 litigation in Federal District Court was not consulted about the agreement. Apparently, the first he heard of an agreement was on 25 August 1976 when he received a congressional inquiry about the Newport News press release. He asked Navy lawyers to send him the settlement terms, but the Navy lawyers themselves did not yet know the terms of the agreement.

- Naval Sea Systems Command personnel have been asked, after the fact, to try to calculate the cost to the Government of the agreement. Apparently a memorandum of legal entitlement or other legal documentation in support of the agreement has not yet been prepared, nor can it be until the cost of the agreement is identified.

- The Newport News press release announcing the CGN 41 agreement may have caught some Navy officials by surprise. However, it is rumored that the press release was either initiated by or cleared with Mr. Rule and retired Vice Admiral Eli Reich before release.

12. Any CGN 41 settlement will no doubt be cited by Newport News as a precedent for settling the $894 million backlog of their claims. In fact, their press release suggests this. The other shipbuilders can be expected to demand concessions along the lines made to Newport News.

13. I consider that cognizant and knowledgeable Navy officials should carefully consider any proposed settlement offer, "handshake" or formal, before it is made. In this case, a particularly careful review would seem warranted in view of Mr. Rule's well-publicized views on the shipbuilding claims problem. In reference (c) I commented on some of those views. Further, since the CGN 41 dispute is under litigation, there should be full consultation and agreement with the Department of Justice. Apparently this review was not done.

14. Should Navy or Justice officials subsequently disapprove the CGN 41 agreement, Newport News will no doubt then argue in court that the Navy did not negotiate in good faith. I am concerned that within the Navy it will be argued that, since the Navy negotiator has made an agreement, Navy personnel must now work to develop a case in support of that agreement, no matter what its terms.

15. I recognize the difficulty of negotiations with Newport News. I would like to see the CGN 41 issue and the claims issues with Newport News settled through negotiations. The claims and litigation detract from ongoing work. On the other hand, the Navy must insist that its contracts be honored. Otherwise, whenever contractors encounter financial difficulties they will seek to get the Navy to absorb the overrun by contesting

the validity of their contracts, by submitting large claims, by litigation, or by stopping work. If the Navy does not enforce its contracts, the claims problem will increase, not diminish, we will lose technical control of our work, and the cost will increase– thus decreasing the number of ships.

16. In summary, I reiterate my recommendation that, prior to approval, any proposed CGN 41 settlement be referred formally to the Naval Sea Systems Command for review and comment by knowledgeable personnel directly responsible for the work in question.

H. G. Rickover

Copy to:
Secretary of the Navy
Assistant Secretary of the Navy
(Installations & Logistics)
Navy General Counsel
Chief of Naval Operations
Vice Chief of Naval Material
Commander Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

12 August 1976

MEMORANDUM FOR MR. GORDON W. RULE

The attached Memorandum to File presents my remembrances of the gist of our telephone conversation this morning. I would appreciate it if you would inform me of any inaccuracies or omissions.

D. T. Leighton

Enclosure

Copy to:
COMNAVSEA
SEA 02
SEA 00L

Leighton-08
Concurs with changes.
8/13/76

12 August 1976

MEMORANDUM TO FILE:

Subj: Telephone Conversation with Mr. Gordon W. Rule

1. Gordon Rule telephoned me this morning. He said that he assumed I knew about the difficult assignment he was working on concerning the CGN 41. I said that I had not seen a charter for his assignment so I didn't know precisely what his responsibilities were. He said that Secretary Bowers had signed a Memorandum to the Chief of Naval Material assigning him as the prime negotiator for the CGN 41. I said that I had seen a piece of paper that did that, but I hadn't seen any other documents assigning specific responsibilities. He said that Mr. Bowers' memorandum was the only document.

2. He said that he would like to be sure that anything he negotiates is palatable to the NAVSEA 08 organization and that he had heard that we were adamantly opposed to negotiation and wanted the matter litigated under any circumstances. He wanted to determine whether that was the NAVSEA 08 position.

3. I said that 08 would much prefer to negotiate a satisfactory resolution of the matter within the terms of the contract rather than to have to go through litigation to resolve it. I said that 08 had cooperated in all the Navy's attempts to negotiate and that I had been a member of the negotiating team. I said that RADM Evans had tried to negotiate our differences in relation to the open items of the contract. I noted that the transcript of RADM Evans' negotiations showed that the Navy had been successful in negotiating the cost of material and the man-hours of direct labor and engineering effort involved with all changes up through November 1975, but was unable to get Newport News to negotiate a settlement within the terms of the contract. I said that all the prior Navy negotiators had been instructed by their superiors that the Navy was free to negotiate the open items of the contract, but that any change in the basic contract would require adequate consideration, as was true in any contract. I said the problem was that Newport News was not willing to negotiate within the terms of the contract. Newport News takes the position that no contract for CGN 41 exists, and therefore, we should negotiate a new contract. Mr. Rule agreed that this is the position of the parties.

4. I emphasized that I am not a lawyer and not a contracting officer and therefore I am not in a position to make decisions concerning contractual matters. I noted, however, that in all the prior attempts to negotiate with Newport News that Navy officials up through the Under Secretary of the Navy had directed Navy negotiators to negotiate within the framework of the existing contract and to obtain adequate consideration if contract provisions were to be changed. I said that, from my knowledge of the case, those instructions appeared to me to be sound. I said that since the Navy considers there is a contract for the CGN 41 and Newport News considers there is not, I did not see how one could negotiate the issue of whether there is or isn't a contract.

5. Mr. Rule said that if negotiations were confined to the eight open items in the contract, the contract delivery date and the ceiling price could not be

changed. I said that if delays in the ship were the Government's responsibility, then, of course, the contract delivery date could be changed by an appropriate amount. I then asked the rhetorical question: "From the taxpayers standpoint, if the delay is not the Government's fault why should the Government agree to extend the delivery date and increase the price accordingly?" I said it seems to me that to the extent the delivery date is extended for reasons that are the contractor's responsibility, the Government should not pay for it.

6. I said that RADM Evans, when he was assigned the job of CGN 41 negotiator, had gone into the matter in great length. I noted that RADM Evans had had no prior direct experience with 08 and could not be considered an 08 advocate. I noted that in order to understand the CGN 41 option, he had studied the CGN 38 contract and had personally read the nine volumes of the CGN 38 claim. Mr. Rule said that there was nobody who did his homework more thoroughly than RADM Evans. I said that RADM Evans had concluded that it was necessary to determine how much the Navy owes within the contract, and therefore, he had tried to negotiate with Newport News the outstanding items within the contract to see if he could reach agreement on what the Navy actually owes them. I said that he soon found that Newport News did not want to negotiate within the contract.

7. Mr. Rule noted that once you have determined what you owe Newport News within the contract, the only basis for increasing the amount would be to use the "ephemeral concept" of "litigative risk". I said that it was my understanding that the Navy lawyers, the contracts people, and the Justice Department, were very concerned over the precedent which could be established by this case if a contractor were allowed to simply take a contract he didn't like, tear it up, and negotiate a new one. I said that it appeared to me that they were right to have this concern, as it might jeopardize all other contracts. Therefore, using "litigative risk" to justify reopening the contract appeared to me to be very dangerous.

8. I said that 08 would certainly prefer not to have to litigate the matter if a satisfactory solution within the contract could be worked out. I said, however, that 08 is not afraid of litigation. I noted that Newport News in their court case is making a personal attack on Admiral Rickover and on me based on the legal theory that 08 has an improper influence on contract decisions; and, therefore, the contract is illegal because the contracting officer is not free to make independent judgments and decisions. I noted that Newport News had made some wild charges in this regard, but that we were not in the least bit concerned about the Navy's ability to rebut them. Mr. Rule wanted to know where he would find these charges made by Newport News. I pointed out that some of them are in their June 18, 1976 letter from Mr. C. E. Dart to Admiral Hopkins. Mr. Rule said that he had read that letter. I said that additional documentation of the Newport News allegations in this regard is contained in their recent affidavits to the Court. I also noted that when the GAO ruled in the Navy's favor concerning the exercise of the option, the legal briefs filed by Newport News saying that they were going to litigate the GAO decision cited as one of their defenses the "improper" influence of 08 in contracting matters. I said that the facts would clearly not support these Newport News allegations.

9. Mr. Rule said that he was glad to hear that NAVSEA 08 was not unalterably opposed to negotiations. I reiterated that 08 has cooperated and will cooperate in all the Navy's attempts to negotiate the CGN 41 within the terms of the contract, but that Newport News has consistently refused to do so. Mr. Rule agreed that to go beyond the terms of the contract without adequate consideration could have far-reaching ramifications.

D. T. Leighton

SEA 0224/GMG
N00024-70-C-0252
Ser 1820

22 JUL 1976

FROM: Commander, Naval Sea Systems Command
TO: Director, Procurement Control and Clearance Division
NAVMAT 022

Subj: CGN 41, Request for Information Concerning

Encl: (1) Copy of Modification P00018 to Contract N00024-70-C-0252
(2) Copy of NAVSEA letter 0221/RJW, N00024-70-C-0252, Ser 491 of 28 May 1975
(3) Copy of NAVMAT Memorandum for Record, MAT 00:FHM, 00 Memo 9-75 of 20 May 1975
(4) Copy of NAVSEA letter PMS 378/FTM, Ser 2003, of 7 January 1976
(5) Copy of NAVSEA Counsel Memoradum for File 00L/DWJ, Ser 32 of 31 January 1975
(6) Copy of OGC Memorandum for Rear Admiral Evans of 4 December 1975
(7) Copy of MAT 02 Memorandum for the Chief of Naval Material of 25 Apr 1975, with enclosures.

1. In reference (a) you requested information on the issues which the Navy considers require negotiation concerning the CGN 41. Enclosure (1) hereto is a copy of bilateral contract modification P00018, which enumerates the eight items remaining to be negotiated under the CGN 41 option.

2. The basic issue between Newport News and the Navy is and has been whether or not a contractual requirement exists for Newport News to construct and deliver CGN 41. As stated by Secretary Middendorf in his 6 July 1976 letter to the Attorney General:

> " . . . it has been the Government's belief that a valid contract exists and that negotiations should be limited to those areas expressly left open in this contract. Newport News has taken the position that no contract exists and that a settlement equitable to both parties should be reached without regard to the terms of the contract."

3. Enclosure (2) hereto describes the Navy's position on five of the eight issues set forth in enclosure (1). Enclosure (3) hereto is a record of the meeting at which senior Navy officials, through the Under Secretary of the Navy, approved the positions taken in enclosure

SEA 0224/GMG
N00024-70-C-0252
Ser 1820

Subj: CGN 41, Request for Information Concerning

(2). The three issues not discussed in enclosure (2) are considered easily resolvable once the other issues are settled. As stated in enclosure (4), the Navy and Newport News negotiated an agreement as to direct manhours and material costs for all changes issued subsequent to Modification P00018, through 30 November 1975. Enclosure (4) further states that the net productive manhour increase required to incorporate the changes in CGN 41:

> ". . . is only 18,474 productive manhours, a figure about 0.3% of the direct productive effort Newport News has estimated will be required to build the CGN 41. This is, of course, in addition to the engineering effort of 8,416 manhours and a material cost of $348,590 in base year dollars to which we have also mutually agreed. You have, however, reserved your rights to further adjustment due to burden rates yet to be determined and to your allegation of 'impact' which still must be resolved."

4. In reference (a) you stated that you want to be able to distinguish between the issues of substance and others. The documents recently filed by Newport News at U.S. District Court address an issue which Newport News has created regarding the Navy's alleged failure to negotiate in good faith as cited in the memorandum of understanding and the court order. Enclosures (5) and (6) discuss the intent of the parties in drafting and executing the memorandum of understanding and Counsel's opinion regarding the proper scope of negotiations with Newport News.

5. Newport News has also indicated they may try to challenge the validity of the CGN 38-41 contract based on memoranda the company prepared at the time of contract negotiation. Enclosure (7) provides the Navy position in this regard. There are numerous other issues and purported issues which have been raised in connection with the controversy. Background information on these and other matters will be furnished to you by separate memorandum.

6. In recent years, the people most knowledgeable about the CGN 41 contractual problems have been Rear Admiral Renfro, Mr. R. Walsh, and recently, Rear Admiral Evans. Unfortunately, these people are no longer available within the Navy for assistance. Therefore,

SEA 0224/GMC
N00024-70-C-0252
Ser 1820

Subj: CGN 41, Request for Information Concerning

Mr. G. Gehrman, SEA 0224, will be the primary point of contact for additional information contained in SEA 02 files, with Mr. M. Ward, SEA 022, as an alternate.

L. E. HOPKINS
Deputy Commander for Contracts

Copy to:
SEA 02(r)
022(r)
0224(b,p,y)
09G55
VCNM
MAT 02
SEA 00
001
PMS 378

Drafted by: G. Gehrman/0224/27601
Typed by: S. Haines/7-21-76
REtyped by: M. Buckingham 7-22-76

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

30 August 1976

MEMORANDUM FOR THE CHIEF OF NAVAL OPERATIONS

Subj: CGN 41 Negotiations with Newport News

Ref: (a) Deputy SecDef memo to CNO of 26 Aug 76; Subj: Admiral Rickover's memo of 24 Aug 76 concerning the CGN 41 Negotiations with Newport News
(b) CNO memo to me of 28 Aug 76; Subj: CGN 41 Negotiations with Newport News Shipbuilding and Dry Dock Company
(c) CNM memo to me of 26 Aug 76; Subj: CGN 41 Negotiations with Newport News Shipbuilding and Dry Dock Company
(d) My memo to CNM of 27 Aug 76; Subj: CGN 41 Negotiations with Newport News

1. In reference (a) the Deputy Secretary of Defense commented on my 24 August 1976 memorandum to the Chief of Naval Material concerning the CGN 41 negotiations with Newport News. Reference (a) states, in part:

". . . it was and is my clear understanding that both you and Admiral Michaelis, in early July, advised Admiral Rickover of the nature of the Navy's plan to resolve the many issues at Newport News and requested his cooperation in support of this plan. You assured me you received Admiral Rickover's full support.

* * * * * * *

"This memo constitutes destructive criticism by an officer of the Navy of highest rank who has no contractual responsibility in the matter. The memo is counter productive and implies bad faith on the part of the Navy and its designated representative by suggesting that Mr. Rule's performance and knowledge as the Navy's negotiator on the CGN-41 matter has been highly suspect and not in the interest of the Government.

* * * * * * *

"I feel sure that Admiral Rickover has ready access to you, and he knows he can contact me any time. In this instance he has chosen to make formal and wide distribution of his opinions without giving you or me an opportunity to receive his advice or counsel which I consider to be a breach of his agreement with us. Certainly his gratuitous memo violates the spirit of his commitment to respond only as requested. Will you please look into this "flap" and let me know what you find and what action might be indicated."

2. This morning, reference (b) was hand-delivered to my office. It was signed in your absence by the Vice Chief of Naval Operations and forwarded reference (a) as an enclosure. Reference (b) states, in part:

"I am in agreement with the views expressed by Secretary Clements and consider that your action violates the understanding that you remain apart from all aspects of Newport News negotiations except as specifically required with regard to details of the nuclear power plant.

"I believe that the spirit and intent of the DEPSECDEF memo is clear and that this endorsement is likewise clear. I expect you to refrain from actions both direct and indirect that are not in compliance with such spirit and intent. Should this memo not be clear, I expect you to consult personally with the Chief of Naval Operations and the Chief of Naval Material."

3. Reference (b) is the third time I have been contacted by senior Navy officials as a result of my 24 August memorandum. On 25 August I received a telephone call from the Vice Chief of Naval Operations, advising me to keep a low profile, and to make no comments and to stay out of any Newport News claims or contractual matters. I also received a memorandum from the Chief of Naval Material, reference (c), stating that I must "stand apart" from the CGN 41 negotiations "unless the technical areas regarding naval nuclear reactors become involved."

4. As I explained in reference (d), which you and the Vice Chief of Naval Operations may not have seen prior to the signing of reference (b), I have not been involved in the CGN 41 negotiations subsequent to 14 July 1976 when Mr. Rule was assigned as CGN 41 Negotiator. I have had no discussions regarding CGN 41 negotiations with Newport News or Mr. Rule. I have reported to my superiors information which should be of concern to

them in carrying out their assigned responsibilities. What use my superiors make of such information is up to them. I trust that reference (d) should alleviate apparent concern regarding my role in the CGN 41 dispute.

5. In view of the reaction to my 24 August memorandum, I would like to set the record straight regarding statements to the effect that in early July I was "advised of the nature of the Navy's plan to resolve the many issues at Newport News" and gave my "full support."

6. The agreement growing out of the 29 June meeting you and I had with the Deputy Secretary of Defense is well documented. A special, 3-man Navy Claims Board, consisting of technical, procurement, and legal experts, was established to handle the Newport News claims solely on their merits. It was agreed that this Board should be insulated from outside pressures. The Deputy Secretary and the Chief of Naval Material subsequently issued instructions that all Defense Department personnel should stand apart from the claims resolution activities of the Board, except to provide assistance as requested by the Board. I agreed to cooperate fully with the Board on those terms and I have done so.

7. I do not recall, however, any subsequent discussions with you, the Chief of Naval Material, or any other Government official, in which I was informed of the Navy's plans to resolve other issues involving Newport News. For example, the first I knew of the Navy's change in plan for handling the CGN 41 dispute was on 14 July 1976 when I received notice from the Secretary of the Navy that the CGN 41 Steering Group, of which I was a member, was abolished. I subsequently learned that Mr. Rule was assigned as CGN 41 Negotiator and that the Navy CGN 41 negotiating team headed by Rear Admiral L. E. Hopkins, the Naval Sea Systems Command Director of Contracts, had been disestablished.

8. The CGN 41 dispute has not been assigned to the Navy Claims Board. As explained in reference (d), the work of my organization is directly affected by the commitments made by the Navy in the CGN 41 dispute. Mr. Rule's actions would appear to be subject to the same legal, technical, and procurement reviews and approval as any other Navy procurement. I consider that Navy officials in these areas should therefore be consulted in advance and kept fully apprised of developments and potential problems. I consider that the same should apply to other Newport News problem areas which are not being addressed by the Claims Board.

9. In summary, I have not reneged on any prior understandings, nor do I consider either my correspondence nor my conduct improper. I have not and will not interfere with the Navy Claims Board. However, I do have a responsibility, like any other Government employee, to report to my superiors potential problems of which I become aware. As explained in reference (d), I intend to do this to the best of my ability. If this is contrary to the spirit and intent of references (a) and (b), I would be glad to meet at any time with you and the Chief of Naval Material, as suggested in reference (b), to clarify the matter.

H. G. Rickover

Copy to:
Secretary of the Navy
Chief of Naval Material
Commander Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
6 October 1976

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: CGN 41 Negotiations

Ref: (a) Summary of Meeting with CNM on Navy-Newport News Matters at 1515 hours, 10 Sep 76
(b) MAT 022 Memo for CNM of 20 Sep 76
(c) MAT 022 Memo for Navy General Counsel of 27 Sep 76
(d) NAVSEA 02 Memo for CNM of 7 Feb 75
(e) My Memo for CNM of 24 Aug 76
(f) My Memo for CNM of 27 Aug 76

1. On 10 September 1976, Mr. Leighton of my staff met with you and Captain Thompson of your staff to discuss CGN 41 related matters. With my agreement, Mr. Leighton had requested this private meeting in response to allegations made about him. Reference (a) summarizes that meeting.

2. In reference (b), distributed to the Deputy Secretary of Defense, the Secretary of the Navy, and others, Mr. Rule complained to you that Mr. Leighton has interfered with his efforts as the CGN 41 negotiator and that "NAVSEA 08--Mr. Leighton in particular--has actively opposed and interfered with the implementation" of the CGN 41 agreement Mr. Rule had negotiated with Newport News. Mr. Rule asked for, and I understand was subsequently given, a copy of reference (a).

3. Using reference (a) as a springboard, Mr. Rule issued reference (c) which he also distributed to the Deputy Secretary of Defense, the Secretary of the Navy, as well as other Defense and Navy officials. Reference (c) contends that the court will void the CGN 41 option because of Mr. Leighton's involvement in the DLGN 38 Class contract negotiations, and because the Navy arranged for Tenneco and Newport News officials to withdraw and disavow a Newport News memorandum dated 22 November 1971. That memorandum was prepared by Mr. C.L. Willis and purports to be an account of negotiations leading to award of the contract for construction of the DLGN 38 Class ships (now CGN 38 Class). Mr. Rule cites the Willis memorandum as demonstrating that Mr. Leighton "usurped negotiating authority" and that he "negotiated that contract in a most dictatorial and improper fashion." Mr.

Rule suggests that NAVSEA 08 was "exercised" about the Willis memorandum because of what it might reveal about Mr. Leighton's dominant role in the negotiations.

4. Newport News first raised the 1971 Willis memorandum as an issue with senior Defense and Navy officials in February 1975. At that time, the circumstances surrounding the company's agreement to withdraw and disavow the Willis memorandum were reviewed by RADM E.E. Renfro, the then NAVSEA Director of Contracts. RADM Renfro reported the results of his review in reference (d); this review indicated nothing improper with the Navy's handling of the matter.

5. Reference (d) explains that Newport News in November 1971 attempted to condition acceptance of the DLGN 38 Class contract on a 31-page Newport News memorandum purporting to be minutes of the negotiation prepared by Mr. Willis while he was a member of the Newport News negotiating team; that the memorandum was self-serving and inaccurate in nearly all respects. As soon as the Willis memorandum was submitted by Newport News in November 1971, RADM K.L. Woodfin, NAVSEA Director of Contracts at that time, recognized that some day it might be argued that the Newport News memorandum, not the signed contract, reflected the agreement. He immediately rejected the conditioned contract.

6. The Willis memorandum was incomplete as to the people who participated in the negotiations, what was said, as well as the context of the negotiations. The Willis memorandum failed to address adequately the discussions leading to the prior five-ship proposed contract and how these discussions affected the negotiations for the three-ship contract referred to in the memorandum. Many statements in the Willis memorandum attributed to Mr. Leighton, Mr. Greer, and others were either incorrectly reported or stated out of context. Further, the memorandum did not address the status of the shipbuilding program at that time, an understanding of which is necessary to understand the context of the negotiations. All of this, as well as specific incorrect statements in the Willis memorandum, was pointed out at the time to Mr. L.C. Ackerman, then President and Chairman of the Board of Newport News. Mr. Ackerman had attended some of the negotiations himself. He recognized some statements in the memorandum which incorrectly reported dialogue in which he had participated. Based on this review, Mr. Ackerman agreed to sign his letter of 23 November 1971 to RADM Woodfin which stated in part:

"After reviewing Mr. Willis' memorandum, I agree with you that it does not adequately reflect what transpired during the negotiations and is inaccurate in virtually all respects.... I want to confirm that all copies of Mr. Willis' memorandum have been destroyed."

7. I assisted RADM Woodfin in getting Mr. Ackerman to disavow and destroy the Willis memorandum. We both agreed, as did Mr. Ackerman at the time, that no point would be served in trying to correct the memorandum. The three of us agreed, and Mr. Ackerman so stated in his 23 November 1971 letter, that "the contract as written and executed constitutes the entire understanding and agreement of the parties."

8. At that time Mr. Rule asked about this incident. It should be noted that he subsequently conditioned his 2 December 1971 approval of the contract post-negotiation business clearance on the basis:

"That no letters of understanding, aide memoire or correspondence of the contractor's interpretation of clauses be accepted or recognized in connection with this procurement."

9. Upon Mr. Rule's assignment as CGN 41 negotiator in July 1976, the present NAVSEA Director of Contracts, RADM L.E. Hopkins, forwarded to Mr. Rule a copy of reference (d). He was also furnished a copy of my letter of 6 August 1975 to Mr. N.W. Freeman, then Chairman of the Board of Tenneco, which summarized this entire incident. Apparently someone at Newport News furnished Mr. Rule a copy purporting to be the Willis memorandum, even though Mr. Ackerman had certified in writing that all copies had been destroyed. Mr. Rule, without checking with the Government personnel involved to determine all the relevant facts, now seems to be going out of his way to establish credibility for a Newport News document which the President of Newport News agreed at the time, and certified in writing, was "inaccurate in virtually all respects." Further, even if the Willis memorandum were accurate--which it is not--it does not support Mr. Rule's allegations of improper conduct of the negotiations on the part of anyone in the Navy, including Mr. Leighton.

10. Mr. Rule appears to believe that in shipbuilding negotiations NAVSEA 08 representatives should confine themselves to giving only technical advice. However, the Armed Services Procurement Regulation specifically provides that:

> "The contracting officer shall avail himself of all appropriate organizational tools such as the advice of specialists in the fields of contracting, finance, law, contract audit, packaging, engineering, traffic management, and price analysis."

11. The contract post-negotiation business clearance Mr. Rule approved on 2 December 1971 identifies by name all members of the Navy's negotiating team, all of whom reported to the contract negotiator, Mr. Irwin Lee. In addition to personnel representing the NAVSHIPS contracting officer, Ship Acquisition Program Manager, NAVSHIPS Counsel, NAVSHIPS Comptroller, the Supervisor of Shipbuilding, and the Defense Contract Audit Agency, there were four NAVSHIPS 08 representatives on the team including Mr. Leighton and Mr. M.C. Greer.

12. My representatives on this team were well-versed in ship contract matters. In fact, in such matters they are among the most experienced and knowledgeable people in Government. Mr. Leighton is not only a technical expert, but has broad administrative experience. Through more than twenty years of participation in ship contract negotiations, he has acquired an understanding of the intricacies and subtleties of shipbuilding contracts that are not apparent to some procurement professionals--who may not have been personally involved in the details of shipbuilding negotiations to the extent Mr. Leighton has. Mr. Greer is an acknowledged procurement expert. He was awarded the Navy Distinguished Civilian Service Medal for his outstanding performance in cost control, accounting, and other procurement-related matters. Mr. Rule himself has publicly cited Mr. Greer as an example of the type of highly trained career civil servant whom he thought, the three military services should be assigning as Assistant Secretaries for Installations and Logistics. Assistant Secretary Bowers offered Mr. Greer a position on his staff as the senior Navy official responsible for Navy procurement policy. Mr. Greer chose instead to remain at the Energy Research and Development Administration (ERDA) where he is now the Controller. NAVSHIPS would have been negligent not to enlist their aid during contract negotiations for nuclear ships.

13. Moreover, Mr. Rule should know that it has been normal practice for members of NAVSEA negotiating teams to participate fully in all aspects of shipbuilding negotiations. He, himself, observed some of the negotiation sessions for the NIMITZ Class carrier contract. His representative, Mr. Burdick, attended some of the DLGN 38 Class contract negotiations.

14. NAVSHIPS officials welcomed the participation of experienced personnel such as Mr. Leighton and Mr. Greer in the negotiations. At the time, the contract negotiator, Mr. Irwin Lee; the NAVSHIPS Director of Contracts, RADM Woodfin, who attended some of the negotiations; and COMNAVSHIPS, RADM N. Sonenshein, the Contracting Officer who signed the contract; all were well aware of and sanctioned participation of my representatives in the negotiations.

15. The recent CGN 41 negotiations which Mr. Rule has been conducting with Newport News are the only ship contract negotiations I have heard of where technical and legal experts were not included on the negotiating team. Why Mr. Rule has elected to conduct Navy business without such assistance is unknown to me. However, it may account in some measure for the results.

16. In references (b) and (c), Mr. Rule stresses by underlining that Mr. Leighton "is not even a Navy employee on the Navy payroll." That has nothing to do with the issue. Since the inception of the Naval Nuclear Propulsion Program, it has been understood by all officials concerned that this is a joint Navy-ERDA (formerly AEC) program and that each person in my organization is paid by one of the two agencies, but serves both.

17. In reference (c), Mr. Rule also alleges that NAVSHIPS negotiated unrealistically low and unfair prices for the DLGN's. However, on 4 October 1971, Mr. Rule reviewed and approved the NAVSHIPS pre-negotiation position for the contract for DLGN's 38, 39, and 40 with options for DLGN's 41 and 42. He approved lower target costs, target profits and ceiling prices for all five ships than NAVSHIPS was ultimately able to negotiate with Newport News. I cannot understand why Mr. Rule now contends that NAVSHIPS negotiated unrealistic and unfair prices when, before the negotiations, he approved lower ones. Further, on 2 December 1971 Mr. Rule approved the post-negotiation business clearance submitted by the contract negotiator, Mr. Lee, which set forth the negotiated prices and stated "that the pricing arrangements agreed to are fair and reasonable."

18. As a result of Mr. Rule's allegations the Navy General Counsel recently completed an investigation of the matter of the Willis memorandum and of Mr. Leighton's involvement in negotiations of the DLGN 38, 39, and 40 contract, the DLGN 41 option and its subsequent extensions as a result of Mr. Rule's allegations. I understand that Counsel found nothing improper in the way Mr. Leighton or the Navy handled these matters and concluded that the Government's case in the CGN 41 dispute is not damaged thereby.

19. In reference (c), Mr. Rule imputes sinister motives on the part of NAVSEA 08 because an option for DLGN 41 was added to the contract for DLGN's 38, 39, and 40. He contends "that NAVSEA 08 knew no such authority existed" since the Secretary of Defense directed that the Navy proposed multi-year contract for five ships be renegotiated to a three-ship contract. However, the documented record shows that in 1971, Mr. Rule was well aware that the issue was not whether the DLGN 41 and DLGN 42 would be built, but whether they would be built with the TARTAR D fire control system or delayed to incoporate the AEGIS fire control system. In fact, I believe that Mr. Rule was the first to suggest that if the DLGN's 41 and 42 were to be delayed for AEGIS, then the multi-year contract should be for the first three ships only, with the fourth and fifth ships priced as options. In commenting on the pre-negotiation clearance for a five-ship multi-year contract for DLGN's 38-42, Mr. Rule stated in a letter to COMNAVSHIPS of 19 February 1971:

> "If CNO wishes to switch from TARTAR D to AEGIS for the fourth and/or fifth ship, this Office will approve a properly documented and supported multi-year contract for three ships, with priced options for one or two additional ships. If thereafter this major change were made, the integrity of the three ship contract would be preserved and only the pricing of the fourth and/or fifth ship affected."

20. As Mr. Rule states in reference (c), on 27 April 1971 the Deputy Secretary of Defense directed that the five-ship multi-year contract be renegotiated to a three-ship multi-year contract. However, in May 1971 the Deputy Secretary informed Congress that the DLGN's 41 and 42 had not been canceled, but that he had held them up pending further progress on development of future weapons systems such as AEGIS. Subsequently, COMNAVSHIPS proposed to revise the Navy procurement plan to incorporate options for two more ships in the three-ship contract to be renegotiated--DLGN's 41 and 42. This option plan was formally approved by the Navy chain of command through the Secretary of the Navy and cleared informally by the Deputy Secretary of Defense on 6 August 1971. Meanwhile, on 21 June 1971, the Deputy Chief of Naval Material (Procurement and Production) signed a memorandum prepared in Mr. Rule's office which formally approved the NAVSHIPS request to modify the Advanced Procurement Plan to include options for DLGN's 41 and 42 in the contract for DLGN's 38, 39, and 40. Mr. Rule reviewed and approved the NAVSHIPS pre-negotiation position for the three-ship contract with options for the DLGN's 41 and 42 on 4 October 1971. At that time he must have considered that proper authority existed for NAVSHIPS to negotiate the options. Otherwise, why would he have approved the options in the pre-negotiation position?

21. On 9 December 1971, subsequent to the negotiation, the Deputy Secretary of Defense approved a Program Budget Decision to proceed with the DLGN 38 Class program on the basis of a three-ship multi-year contract, with options for two more ships. On 11 December 1971, the Secretary of the Navy requested approval to proceed with the three-ship contract including options for two ships. On 21 December, the Secretary of Defense, after noting that the contract included options for two ships, approved the three-ship contract. Based on the documented record, there can be no doubt that all cognizant Defense and Navy officials were informed of, and approved including options for the DLGN's 41 and 42 in the contract for the DLGN's 38, 39, and 40.

22. From the outset of the CGN 41 dispute, Navy Counsel and the Department of Justice attorneys have held that the Navy has a valid, enforceable contract with Newport News for construction of the CGN 41 and that the company's legal arguments to the contrary are without merit. I understand that counsel still holds this view.

23. Because the Newport News legal position is weak, the company has undertaken in Mr. Diesel's own words, to "bring all the pressure to bear I can for a prompt and equitable resolution of the differences between the company and the Navy." Consistent with this approach, Newport News has made public attacks on the Navy; complained to high level Defense officials; threatened to stop work on Navy contracts, and to take no more Navy shipbuilding contracts. As you know, at one time the company actually stopped work on the CGN 41. Newport News has also been highly critical of me and my staff and even lobbied against my most recent reappointment.

24. In this climate Mr. Rule is sponsoring a settlement that goes beyond the terms of the CGN 41 contract--a contract which both Navy and Department of Justice lawyers consider to be valid and enforceable. I find it particularly objectionable that Mr. Rule is now basing his justification for reformation of the CGN 41 contract on unsubstantiated allegations of misconduct by me, Mr. Leighton, or other members of my staff. And this without even ascertaining the facts. In so doing, he has done a gross injustice to Mr. Leighton whose credentials, accomplishments, and record of performance are well known and beyond reproach.

25. I have not encountered a more dedicated, competent, hard-working Government servant than Mr. Leighton, and I am sure your own experience supports this. He has detailed knowledge of the design and construction of nuclear powered ships based on a quarter of a century of first-hand experience. He has been a valued and much sought-after member of Navy negotiating teams for nuclear submarines and surface ships for two decades.

26. In references (e) and (f), I informed you of rumors that Mr. Rule had negotiated a settlement of the CGN 41 dispute. I explained why I considered that settlement on the terms rumored would not be in the Government's best interest. The terms of the proposed settlement have now been disclosed. They are along the lines I indicated, but even less favorable to the Government than I had originally heard and reported to you.

27. I am convinced that it would be wrong for the Navy to settle the CGN 41 dispute along the lines recommended by Mr. Rule. Mr. Leighton is of the same opinion, as he stated to you during the 10 September meeting. There is no basis to conclude that our opposition to Mr. Rule's proposed settlement constitutes improper "interference" in the performance of Mr. Rule's duties, as he has suggested.

28. Mr. Rule has supplied no facts to support his allegations. Yet he continues to malign Mr. Leighton. He has circulated at all levels of the Defense bureaucracy correspondence containing harshly critical comments regarding Mr. Leighton. The recipients of such correspondence have a right to assume that an official in Mr. Rule's position would not make unsupported charges. Therefore, his correspondence cannot help but be damaging to Mr. Leighton's reputation.

29. I remained silent following Mr. Rule's adverse comments about me in his speech of 2 June 1976 before the Shipbuilders Council of America. However, he has now chosen to launch an unjustified attack on one of my subordinates, using his unsupported allegations to justify the unwarranted payment of tens of millions of dollars of taxpayer funds. Because of this, the record must be set straight.

30. Thorough investigation of Mr. Rule's allegations indicates no evidence of any impropriety or misconduct by Mr. Leighton or other NAVSEA 08 personnel. Therefore, unless you have specific evidence to the contrary, I request that you, as Chief of Naval Material and as Mr. Rule's superior, make it clear that the views expressed in references (b) and (c) do not reflect your views.

31. I am sending a copy of this memorandum to the distribution list indicated in reference (c) so that the recipients of Mr. Rule's memorandum will be informed of the facts contained herein. I suggest that you furnish copies to all who have been furnished copies of references (b) and (c).

32. I request that I be informed of the action you take in response to this memorandum.

H. G. Rickover

Copy to:
Deputy Secretary of Defense
Department of Defense General Counsel
Secretary of the Navy
Under Secretary of the Navy
Assistant Secretary of the Navy
(Installations and Logistics)
Navy General Counsel
Vice Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
MAT00:FHM:by
00 MEMO 681-76
14 October 1976

MEMORANDUM FOR ADMIRAL H. G. RICKOVER

Subj: CGN-41 Negotiations

Ref: (a) MAT-022 Memo for CNM of 20 Sep 1976
(b) MAT-022 Memo for Navy General Counsel of 27 Sep 1976
(c) Your Memo for CNM of 6 Oct 1976

1. The allegations in references (a) and (b) concerning Mr. Leighton, which you state in reference (c) to be inaccurate, are Mr. Rule's personal assessment of the facts as he sees them. They are not my statements. The overall conduct of the CGN-41 negotiations, including the role played by NAVSEA personnel, has been reviewed by OGC in its assessment of the proposed settlement. It is now being considered by the Department of Justice as a part of its responsibilities in the conduct of this case, and thus it would be inappropriate for me to comment further at this time.

F. H. Michaelis

Copy to:
Deputy Secretary of Defense
Department of Defense General Counsel
Secretary of the Navy
Under Secretary of the Navy
Assistant Secretary of the Navy
(Installations and Logistics)
Navy General Counsel
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
14 OCT 1976

MEMORANDUM FOR COUNSEL, NAVAL SEA SYSTEMS COMMAND

Subj: Employment of Outside Legal Counsel in Navy Matters

Ref : (a) Vice Chief of Naval Operations Memorandum for the Chief of Naval Material dtd 9 Oct 76

Encl: (1) List of private attorneys and law firms furnishing services in connection with the Naval Nuclear Propulsion Program since 1 July 1974

1. Reference (a) states that concerns have recently been raised regarding the possible use of appropriated funds for outside legal counsel in matters that involve or affect the interests of the Department of the Navy. Reference (a) does not identify the source of these concerns. Reference (a) requests that a list of private attorneys and law firms furnishing services either directly to the Navy or to contractors since 1 July 1974 be submitted to the Chief of Naval Operations. The stated purpose of this request is "to identify all lawyers and law firms furnishing services to the Government in any way in connection with Naval Material Command matters."

2. No private law firms or attorneys have been engaged by NAVSEA 08.

3. NAVSEA 08 is aware of some of the law firms and attorneys who have been retained by contractors in connection with contract disputes, Freedom of Information Act requests, and other legal matters related to the Naval Nuclear Propulsion Program. In view of the request of reference (a) to identify all law firms and attorneys providing direct or indirect legal services to the Government and because of the expressed concern regarding use of appropriated funds, all law firms and attorneys known to have furnished legal services to contractors in matters related to the Naval Nuclear Propulsion Program have been identified. These law firms or attorneys are listed in enclosure (1). No doubt there are many more.

4. Since the Naval Nuclear Propulsion Program is a joint program of the Navy and the Energy Research and Development Administration (ERDA), enclosure (1) includes law firms and attorneys performing services related to Naval Nuclear Propulsion under ERDA procedures.

H. G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Sea Systems Command

LIST OF PRIVATE ATTORNEYS AND LAW FIRMS FURNISHING SERVICES IN CONNECTION WITH THE NAVAL NUCLEAR PROPULSION PROGRAM SINCE 1 JULY 1974

In the following list, Babcock and Wilcox Company, Naval Nuclear Division (B&W NNFD); General Electric Knolls Atomic Power Laboratory (GE-KAPL); General Electric Machinery Apparatus Operation (GE-MAO); United Nuclear Corporation, Naval Products Division (UNC NPD); Westinghouse Bettis Atomic Power Laboratory (Westinghouse Bettis); and Westinghouse Plant Apparatus Division (Westinghouse PAD) are Government prime contractors in the Naval Nuclear Propulsion Program. General Dynamics, Electric Boat Division (EB); Newport News Shipbuilding and Dry Dock Company (NNS&DD); and Ingalls Shipbuilding Division, Litton Systems, Inc. (Ingalls) are private shipbuilders performing both nuclear and non-nuclear work.

Private Attorney or Law Firm and Address	Matter on Which Advice or Service was Obtained
Beveridge, Fairbanks, & Diamond Farragut Square South Washington, D. C.	Counsel for GE-KAPL in a dispute with a subcontractor, Newport News Shipbuilding and Dry Dock Company.
Albert G. Busser 744 Broad Street Newark, New Jersey 107102	New Jersey representative for Cole and Groner in connection with a civil suit brought against GE-MAO by a subcontractor, Curtiss-Wright Corporation.
Christie, Parker, and Hale 201 South Lake Avenue Pasadena, California 91101	Counsel to Royal Industries regarding the evaluation of a potential patent infringement under Navy prime contract with Westinghouse Bettis.
Cole & Groner 1730 K Street, N.W. Washington, D. C. 20006	1. Counsel to GE-MAO for performance of independent factual review of a request by a subcontractor, Curtiss-Wright Corporation for relief under P.L. 85-804. 2. Counsel to GE-MAO concerning a civil suit brought against GE-MAO by a subcontractor, Curtiss-Wright Corporation.

Enclosure (1)

Private Attorney or Law Firm and Address (Cont'd)	Matter on Which Advice or Service was Obtained (Cont'd)
Richard F. Corkey New London, Connecticut	Arbitrator selected by General Dynamics, Electric Boat Division, a GE-KAPL subcontractor, in connection with a termination for default of a General Dynamics, Electric Boat Division, subcontractor, Canadian American Constructors.
Covington & Burling 888 16th Street, N.W. Washington, D. C. 20006	1. Counsel to Westinghouse PAD for defense of a civil suit brought by Babcock & Wilcox Company, a subcontractor, alleging defective specifications. 2. Counsel to Westinghouse PAD on claims by Newport News Shipbuilding and Dry Dock Company for alleged late or defective Government furnished equipment and information. 3. Counsel to Westinghouse PAD on a default termination of an Aerojet-General subcontract.
Crummy, Del Deo, Dolan, & Purcell Gateway 1 Newark, New Jersey 07102	Counsel to a GE-MAO subcontractor, Curtiss-Wright Corporation, in a civil suit against GE-MAO.
Dezendorf, Spears, Lubersky & Campbell Portland, Oregon	Counsel to NNS&DD regarding a subcontract dispute.
Dugan, Lyons, Pentak & Brown 100 State Street Albany, New York	Counsel to GE-KAPL in personal injury suit brought by a GE-KAPL employee.
Eckert, Seamens, Cherin & Mellot 600 Grant Street Pittsburgh, Pennsylvania 15219	Counsel to Westinghouse Bettis on issues such as workmen's compensation, tort, & breach of employment contract claims.
Edmunds, Williams, Robertson, Sackett, Baldwin, & Groves 916 Main Street Lynchburg, Virginia 24504	Counsel to B&W, NNFD in connection with Naval Nuclear Propulsion Program work.

Private Attorney or Law Firm and Address (Cont'd)	Matter on Which Advice or Service was Obtained (Cont'd)
Foley, Hoag, & Eliot 10 Post Office Square Boston, Massachusetts	1. Counsel to GE-KAPL in a default termination against Process Equipment Corporation. 2. Counsel to EB regarding labor relations.
Furgeson & Mason Norfolk, Virginia	Counsel to NNS&DD regarding CGN 41 option dispute.
Hamel, Park, McCabe & Sanders 1776 F Street, N.W. Washington, D. C.	Counsel to NNS&DD regarding CGN 41 option dispute.
Harry R. Hayes 116 Washington Avenue Albany, New York	Counsel to M-Gard Construction, in a claim against General Dynamics, Electric Boat Division, a GE-KAPL subcontractor.
Holden, Holden, Kidwell, Hahn, & Crapo P.O. Box 129 Idaho Falls, Idaho 82401	Counsel to interested firms in contest of a subcontract award by Westinghouse Bettis.
Joel M. Howard 75 State Street Albany, New York	Counsel for Canadian American Constructors in a termination for default of work subcontracted by General Dynamics, Electric Boat Division, which is a GE-KAPL subcontractor.
James, Gregg, Creehan & Gerace Grant Building Pittsburgh, Pennsylvania 15219	Counsel to Westinghouse Bettis regarding workmen's compensation claims.
Lawler, Felix & Hall 605 West Olympic Boulevard Los Angeles, California 90015	1. Counsel to Aerojet-General, Westinghouse PAD subcontractor, in Freedom of Information Act issues. 2. Counsel to Aerojet-General, a Westinghouse subcontractor, on a termination for default.
Lowenstein, Newman, & Reis 1100 Connecticut Avenue Washington, D. C.	Counsel for P. F. Avery, a GE-KAPL subcontractor, in a subcontract dispute.

Enclosure (1)

Private Attorney or Law Firm and Address (Cont'd)	Matter on Which Advice or Service was Obtained (Cont'd)
L. Martino Carlton House Hotel Pittsburgh, Pennsylvania	Counsel to Vector Corporation regarding subcontract matters with Westinghouse Bettis.
Maynard, O'Connor & Smith 90 State Street Albany, New York	Counsel to Sweet Associates, subcontractor to General Dynamics, Electric Boat Division, a subcontractor to GE-KAPL, in death compensation suit brought by estate of Sweet employee.
Morgan, Lewis & Bockius 1140 Connecticut Avenue, N.W. Washington, D. C. 20036	Counsel to B&W NNFD in contract matters, including claims for additional compensation for nuclear material safeguards.
Pemberton, Buchyn & O'Hare 701 Union Street Schenectady, New York	Counsel to M. Gold, a GE-KAPL subcontractor, in personal injury suit brought by a GE-KAPL employee.
Penrod, Himelstein, Savinar & Sims 556 Commercial Street San Francisco, California	Counsel to Westinghouse Bettis regarding a breach of employment contract claim.
Plowman & Spiegel Grant Building Pittsburgh, Pennsylvania 15219	Counsel to construction subcontractor to Westinghouse Bettis in connection with claim for additional compensation for rerouting of storm and sanitary sewers.
A. Plum 314 Long Run Road McKeesport, Pennsylvania	Counsel to affected subcontractors for review of a subcontract novation agreement on office equipment services order under Navy prime contract with Westinghouse Bettis.
Pollock, Van Desande & Priddy 1200 18th Street, N.W. Washington, D. C.	Counsel to NNS&DD regarding patent matters.

Private Attorney or Law Firm and Address (Cont'd)	Matter on Which Advice or Service was Obtained (Cont'd)
Quane, Kennedy, & Smith Boise, Idaho	Counsel to Westinghouse Bettis regarding workmen's compensation claim.
Rice, Day, Marsh & Calhoun 955 Main Street Bridgeport, Connecticut	Counsel for a GE-KAPL subcontractor, General Dynamics, Electric Boat Division in an arbitration hearing involving a termination for default of a General Dynamics, Electric Boat Division subcontract with Canadian American Constructors.
Ruckelshaus, Beveridge, & Fairbanks 1 Farragut Square South Washington, D. C. 20006	Counsel to Westinghouse PAD for defense of a civil suit brought by Babcock & Wilcox Company alleging wrongful withholding of subcontract payments.
Sellers, Conner & Cuneo 1625 K Street, N. W. Washington, D. C.	1. Counsel to UNC NPD in contract matters, including issues such as claims for additional compensation for nuclear material safeguards & defective pricing alleged on Government contracts. 2. Counsel to Babcock & Wilcox Company, a subcontractor under Navy prime contracts, in Freedom of Information Act issues. 3. Counsel to Babcock & Wilcox Company, a subcontractor to Westinghouse PAD, for issues such as alleged defective pricing on Navy subcontracts, wrongful withholding of payment, & defective specifications. 4. Counsel to Ingalls regarding claims against the Government. 5. Counsel to EB regarding claims against the Government.

Private Attorney or Law Firm and Address (Cont'd)	Matter on Which Advice or Service was Obtained (Cont'd)
Seyforth, Shaw, Fairweather & Geraldson Chicago, Illinois	Counsel to NNS&DD regarding a subcontract dispute.
Slater, Goldman, Gillerman & Shack 89 State Street Boston, Massachusetts	Counsel to Process Equipment Corporation in a default termination under GE-KAPL subcontract.
Sullivan, Beauregard, Myers & Clarkson 804 Ring Building 1200 18th Street, N.W. Washington, D. C.	1. Counsel for Newport News Shipbuilding and Dry Dock Company in a subcontract dispute with GE-KAPL. 2. Counsel for NNS&DD regarding claims under Government contracts.
Swerdlow, Glikbarg, & Shimer 544 United California Bank Bldg. 9601 Wilshire Boulevard Beverly Hills, California 90210	Counsel to Westinghouse PAD on a termination for default of an Aerojet-General subcontract.
Schnader, Harrison, Segal & Lewis	Counsel to EB regarding various matters.
Suisman, Shapiro, Woll, Brennan & Gray New London, Connecticut	Counsel to EB regarding real estate.
Nixon, Hargrove, Devon & Doyle 900 17th Street, N.W. Washington, D. C.	Counsel to EB regarding labor relations.
Pullman, Connley, Bradley & Reeves Bridgeport, Connecticut	Counsel to EB regarding labor relations.
Jenner & Block Chicago, Illinois	Counsel to EB regarding real estate.
Edwards & Angell Providence, Rhode Island	Counsel to EB regarding subcontract dispute.
Petit, Evers & Martin San Francisco, California	Counsel to Ingalls regarding claims against the Government.

Private Attorney or Law Firm and Address (Cont'd)	Matter on Which Advice or Service was Obtained (Cont'd)
Williams, Connelly, & Califano 839 17th Street, N.W. Washington, D. C.	Counsel to Ingalls regarding Government fraud investigation.
Clark, Steinhilber & Hasheimer	Counsel to Ingalls regarding Government fraud investigation.
Dymond & Krull	Counsel to Ingalls regarding Government fraud investigation.
Freedman, Freedman & Swersky 417 N. Washington Street Alexandria, Virginia	Counsel to Ingalls regarding Government fraud investigation.
Butler, Snow, O'Mara, Stevens & Cannada Jackson, Mississippi	Counsel to Ingalls regarding subcontract dispute.
Brunini, Granthan & Grower Jackson, Mississippi	Counsel to Ingalls regarding litigation on shipbuilding contracts.
Karl Wiesenburg Pascagoula, Mississippi	Counsel to Ingalls regarding labor relations.
Ray W. Pike Pascagoula, Mississippi	Counsel to Ingalls regarding labor relations.
E. L. Zobazie	Counsel to Ingalls regarding labor relations.
Steptoe & Johnson 1250 Connecticut Avenue, N.W. Washington, D. C.	Counsel to Ingalls regarding labor relations.
White & Morse Gulfport, Mississippi	Counsel to Ingalls regarding labor relations.
Parsman, Jones & Andrews	Counsel to Ingalls regarding subcontract dispute.
Kirlin, Campbell & Keating New York, New York	Counsel to NNS&DDCo. regarding a subcontract dispute.
Blank, Rome, Claus & Co.	Counsel to NNS&DDCo. regarding a subcontract dispute.

Private Attorney or Law Firm and Address (Cont'd)	Matter on Which Advice or Service was Obtained (Cont'd)
Christian, Barter, Epps, Brent & Chaprell Richmond, Virginia	Counsel to NNS&DDCo. regarding utility rates.
Marsh, Day & Calhoun Bridgeport, Connecticut	Counsel to EB regarding labor relations.
Henniger & Henniger	Counsel to EB regarding labor relations.
Eckert, Seamens, Cherin & Mellot 600 Grant Street Pittsburgh, Pennsylvania 15219	Counsel to Westinghouse Electro-Mechanical Division, subcontractor to GE-MAO, in a lawsuit involving allowability of costs.
Corcoran, Youngman & Rowe 1511 K Street, N.W. Washington, D.C.	Counsel to Tenneco/Newport News to represent corporate interests.
Reed, Smith, Shaw, & McClay Union Trust Building Pittsburgh, Pennsylvania	Counsel to Duquesne Light, a Government prime contractor, on Equal Employment Opportunity litigation.

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

5 November 1976

Mr. John P. Diesel, President
Newport News Shipbuilding and Dry Dock Company
4101 Washington Avenue
Newport News, Virginia 23607

Dear Mr. Diesel:

I have before me a copy of an article from the Newport News (Virginia) Times Herald of November 2nd, 1976, which states, in part:

> During a meeting with 850 members of shipyard management, John P. Diesel outlined yet another dispute between the shipyard and the Navy that could threaten future Navy shipbuilding...
>
> Diesel also reportedly said Adm. H.G. Rickover, head of the Navy's nuclear propulsion program, wants the shipyard to "play ball" with the Navy in resolving several contract disputes with hundreds of millions of dollars at stake.
>
> Rickover has "threatened" to take the shipyard out of nuclear shipbuilding unless the shipyard softens its position, according to Diesel.
>
> Diesel said the shipyard is completely at odds with Rickover, who Diesel alleged would is (sic) use his "political power" to block the signing of ship contracts with the shipyard, according to the sources.

I have not discussed Newport News claims with you or anyone else from Newport News or Tenneco since you and I met last February at the request of Secretary Clements. I have not made threats to take the shipyard out of nuclear shipbuilding, nor is there any valid basis for you to state that I would use "political power" to block the signing of ship contracts. The only statements of which I am aware which threaten to get Newport News out of nuclear shipbuilding are the ones made by you and other Newport News officials in recent letters to Defense officials.

Please let me know if the quotations above are an accurate report of your statements. If so, I would like to know the specific basis for your allegations concerning me.

Sincerely,

H. G. Rickover

Copy to:
Deputy Secretary of Defense
Secretary of the Navy
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command

NEWPORT NEWS SHIPBUILDING AND DRY DOCK COMPANY
NEWPORT NEWS, VIRGINIA 23607

J. P. DIESEL
PRESIDENT

November 19, 1976

Admiral H. G. Rickover
Commander
NAVSEA 08
Naval Sea Systems Command
Department of the Navy
Washington, D. C. 20362

Dear Admiral Rickover:

The quotations from the press which you have included in your letter of 5 November 1976 were obtained by the press through other sources and, hence, are not literally correct. However, those quotations cover the thrust of my comments.

It is rather astounding that you, of all people, should make inquiry as to the basis of my remarks. You are well aware of your conversations, actions, testimony and memoranda relative to Newport News.

Sincerely,

J. P. Diesel

Copy to:
Deputy Secretary of Defense
Secretary of the Navy
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
24 Nov. 1976

Mr. John P. Diesel
President and Chief Executive Officer
Newport News Shipbuilding and Dry Dock Company
Newport News, Virginia 23607

Dear Mr. Diesel:

In my 5 November 1976 letter I asked you to identify the basis for statements the press has attributed to you to the effect that I had threatened to take Newport News out of nuclear shipbuilding and would use "political power" to block signing of ship contracts. I pointed out that the only statements which I am aware of that threaten to get Newport News out of nuclear shipbuilding are the ones made by you and other Newport News officials in recent letters to Defense officials.

Your 19 November response states that the quotations attributed to you are not literally correct but that they cover the thrust of your comments. You also expressed surprise that I would inquire as to the basis of your remarks, and stated: "You are well aware of your conversations, actions, testimony, and memoranda relative to Newport News."

Because I am well aware of my "conversations, actions, testimony, and memoranda relative to Newport News," I know of no factual basis for the statements attributed to you, whether they are literally correct or if they convey only the thrust of your comments as you contend. This was the reason for my request.

In sum, your 19 November response confirms the point I wanted to make.

Sincerely,

H. G. Rickover

Copy to:
The Deputy Secretary of Defense
The Secretary of the Navy
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command

NEWPORT NEWS SHIPBUILDING,
Newport News, Va., December 17, 1976.

Adm. HYMAN G. RICKOVER,
Department of the Navy, Navy Sea Systems Command,
Washington, D.C.

DEAR ADMIRAL RICKOVER: I had hoped when I wrote my letter of November 19, 1976, responding to your inquiry about some statements attributed to me by the press, that further communication on this subject would be unnecessary. Seeking to avoid a meaningless dialogue with you, I had deliberately refrained from reciting in my November 19, letter the factual bases for my earlier comments.

The statements I have made concerning you and your relationship with this company have always been accurate. By way of example, you know very well that in a telephone converation with me on October 20, 1975, you stated that we were not capable of performing as a design agent because of our contracting posture and threatened to take all design work away from us. Nevertheless, I do not think that further correspondence between us is a satisfactory method of addressing the subject.

I hope that an opportunity will arise in the future for your relationship with this company to be thoroughly detailed. I strongly believe that the most appropriate way to have this relationship accurately and fully disclosed is in a proceeding where a verbatim transcript is made under oath. However, your recent refusal to comply with the Armed Services Board of Contract Appeals order directing you to appear to have your deposition taken, leads me to conclude that you would not willingly submit to such a procedure. In this regard, I am enclosing a copy of my letter to Secretary Middendorf.

Very truly yours,

J. P. DIESEL, *President.*

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

19 Jan 1977

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Response to Allegations by Mr. J. P. Diesel, President, Newport News Shipbuilding and Dry Dock Company

Encl: (1) My letter to Mr. W. E. Scott, Chairman of the Board, Tenneco, dated 19 Jan 1977

1. As you know, in his campaign for rapid settlement of Newport News' claims against the Navy, Mr. J. P. Diesel, President of Newport News, has directed a personal attack on me--contending that I am a major cause of their problems and that I have acted unfairly. Apparently he hopes thereby to help invalidate Navy contracts or obtain claim settlements in excess of amounts legally owed by the Navy.

2. Mr. Diesel's letter to you of 17 December 1976 and his letter to me dated the same day are examples of one effort in this regard. In this case, as in the past, the facts do not support Mr. Diesel's allegations. However, in his 17 December letter to me, Mr. Diesel states:

"I do not think that further correspondence between us is a satisfactory method of addressing the subject."

3. It occurred to me that the inaccurate and misleading information Mr. Diesel submits to senior Defense officials and to the press may be representative of the information he gives to the Chairman of the Board of Tenneco, Mr. W. E. Scott. If so, such misinformation might result in Tenneco decisions which would be inimical to the interests of both Tenneco and the Navy. The record also needs to be set straight so that misinformation conveyed by Mr. Diesel is recognized for what it is.

4. Therefore, I have sent the attached letter to the Chairman of the Board of Tenneco to alert him of the potential problem and to offer him the opportunity to determine the facts if he so desires.

H. G. Rickover

Copy to:
Secretary of Defense
Deputy Secretary of Defense
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

19 Jan 1977

Mr. Wilton E. Scott
Chairman of the Board
Tenneco Incorporated
Tenneco Building
P.O. Box 2511
Houston, Texas 77001

Dear Mr. Scott:

You may recall our conversation some time ago at a Newport News ceremony when I expressed my concern that you might not be getting an accurate picture of events affecting Newport News Shipbuilding and Dry Dock Company. I suggested that you might gain a better insight into problems affecting Newport News by reading my August 6, 1975 letter to Mr. N.W. Freeman, then Chairman of the Board of Tenneco.

I am concerned by the fact that my involvement in matters affecting Newport News continues to be misrepresented by Mr. Diesel both in the press and in correspondence with my superiors. The enclosed correspondence between Mr. Diesel and me illustrates the problem. That correspondence was prompted by press accounts quoting Mr. Diesel as saying that I "'threatened' to take the shipyard out of nuclear shipbuilding" and would use "'political power' to block the signing of ship contracts with the shipyard..."

The only statements of which I am aware that threaten to get Newport News out of naval shipbuilding have been made by Newport News officials. Therefore, I asked Mr. Diesel to identify the specific basis for the public statements about me attributed to him.

In his most recent letter to me of December 17, 1976, Mr. Diesel states:

> "The statements I have made concerning you and your relationship with this company have always been accurate. By way of example, you know very well that in a telephone conversation with me on October 20, 1975, you stated that we were not capable of performing as a design agent because of our contracting posture and threatened to take all design work

away from us. Nevertheless, I do not think that further correspondence between us is a satisfactory method of addressing the subject."

The October 20th telephone conversation mentioned by Mr. Diesel involved a specific case where his subordinates were trying to help solve financial problems on a Navy shipbuilding contract by taking unfair advantage of mistakes made by Newport News under a design contract. What I conveyed to Mr. Diesel in telephone conversations on October 20 and 23, 1975--and in a November 10, 1975 meeting which he requested--was that I could not condone such actions. I told Mr. Diesel that insofar as I was concerned as long as Newport News displayed such an approach, no new work under my cognizance should be put into Newport News unless there were no other alternative. At our November 10, 1975 meeting, Mr. Diesel agreed that his representatives had handled the matter incorrectly and apologized for their actions. Our meeting was a pleasant one and I left it thinking we had put that specific matter behind us. Apparently, Mr. Diesel now wants to reraise it.

The specific incident is well documented, and if you are interested in hearing the facts, I would be glad to set them forth in detail. The facts do not support Mr. Diesel's recent characterization of the situation.

With his letter of December 17, 1976 to me, Mr. Diesel enclosed a letter he had written to the Secretary of the Navy on the same date. In that letter, and in a subsequent letter of January 4, 1977, also to the Secretary of the Navy, Mr. Diesel accuses me of subverting the contracts disputes process because I submitted an affidavit in lieu of appearing for a deposition in relation to two Armed Services Board of Contract Appeals cases. The two cases in question involve the interpretation of technical specifications concerning some components installed in the NIMITZ and EISENHOWER; Newport News claims the Navy owes them about a quarter of a million dollars.

Counsel for Newport News, however, has tried to broaden the issues beyond the facts in dispute. According to rumors circulating in the shipbuilding industry, representatives of Newport News have stated the yard is deliberately using these two relatively minor cases to harass me and my organization.

My personal involvement in these two cases was minimal. It seemed to me it would not be to the advantage of senior Newport News, Tenneco, or Government officials to have their time wasted in depositions on matters extraneous to the issues in dispute. Therefore, upon advice of Navy Counsel, I submitted an affidavit to the Board detailing the extent of my involvement. Counsel for Newport News demanded my deposition, and even went so far as to accuse the Government of attempting to suppress evidence by withdrawing one of its defenses.

The Board, after considering arguments by counsel for both sides, ruled that a deposition by me was not required and that the views expressed by Newport News "with regard to its claim that the Government's action seeks to suppress or exclude evidence are without merit." The Board stated, "The matters to be resolved are relatively straightforward and lacking of any significant legal or factual complications." It directed both parties "to limit any further action taken by them to those matters which are manifestly essential to the conduct of a hearing and early resolution of these appeals."

The information Mr. Diesel reports to you may be no more accurate than the information he disseminates publicly and to my superiors. Therefore, I am concerned that you may have an incomplete or inaccurate understanding of the problems at Newport News as they affect Navy work and my involvement in them. If so, such misunderstandings might result in you making business decisions which would not be in the best interests of either Tenneco or the Navy. Thus, my reason for writing this letter is to be sure that you know there are disparities between the facts and the information Mr. Diesel has been publicizing.

The next time you are in Washington, I would be pleased to meet with you if you care to discuss these or other matters of mutual interest.

Best regards,

H. G. Rickover

Encl:
As stated

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
2 DEC 1977

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (MANPOWER, RESERVE AFFAIRS AND LOGISTICS)

Subj: Withdrawal of Electric Boat Claims from the Jurisdiction of the Navy Claims Settlement Board

Ref : (a) Chief of Naval Material memorandum, 00/588-77 dtd 1 Dec 1977

1. On 28 November 1977, we met at your request and discussed several issues involving the Navy shipbuilding program. During this discussion you mentioned that you had negotiated an arrangement with Litton to suspend litigation on the LHA claim until the end of April, 1978 and that you intended to use the intervening time to seek a Litton settlement. We agreed that, contrary to the allegations of the shipbuilders, many of the cost overruns on current contracts are not the responsibility of the Government. I cited some examples of problems at the Electric Boat Division of General Dynamics which are clearly the contractor's responsibility. You indicated that you recognize that the magnitude of the financial problem at Electric Boat is severe. You also noted that to evaluate the Electric Boat claim you have available the substantial work already done by the Navy Claims Settlement Board on this claim. You stated that you are not interested in any settlement beyond contract terms with either Litton or General Dynamics if it does not result in a substantial financial loss for each company and if it does not provide a clear solution for the future.

2. I just received a copy of reference (a) in which the Chief of Naval Material directed the Chairman of the Navy Claims Settlement Board to terminate his efforts on the Electric Boat claims and to furnish all data developed to date to the Chairman of the Assistant Secretary of the Navy (Manpower, Reserve Affairs and Logistics) Special Steering Group. Also, word is circulating in the Navy that this action was discussed with me during our 28 November meeting.

3. I would like to make clear for the record that, prior to receipt of reference (a), I was not informed of any plans to terminate the Navy Claims Settlement Board efforts on the Electric Boat claims. Nor was I aware of the

existence of an "ASN(MRA&L) Special Steering Group." I have no knowledge of its composition, its functions nor why this group is being given responsibilities previously assigned to the Navy Claims Settlement Board.

4. In my opinion, the Navy Claims Settlement Board should be permitted to complete its analysis of the Electric Boat claims. Personnel from the Navy Claims Settlement Board, the Supervisor of Shipbuilding, and Naval Sea Systems Command have spent many months evaluating these claims. It is my understanding that the job is not yet complete and the Navy Claims Settlement Board has not made a determination of what the claims are worth.

5. During the meeting, Mr. Leighton and I mentioned the reports I have submitted concerning the possibility of fraud in the Newport News claims. We also noted examples of why the Electric Boat claim may be fraudulent. I noted that, to date, I have documented and reported to appropriate authorities in accordance with Navy directives, four specific instances of apparent fraud in connection with the Newport News claims. I understand these are currently under review by the Navy General Counsel. I am preparing reports of other similar instances, including a report on apparent fraud in the Electric Boat claims.

6. The Navy must try to protect itself against inflated and exaggerated claims. These claims create an unwarranted burden on the Naval establishment; divert technical people from their primary tasks; and can result in claims being settled for far more than they are worth. If Government contractors believe that they can make out financially by submitting grossly inflated claims and then use them as the basis for lump sum settlement negotiations with the Government, we will continue to be plagued with inflated and unwarranted claims in the future.

7. It should also be recognized that Newport News will interpret the Navy's action in assigning the Electric Boat claims to another group as evidence that the Navy is pursuing a settlement with Electric Boat independent of the merits of their claims. No doubt the company will harden its position in dealing with the Board thus making it increasingly unlikely that the Board can settle the Newport News claims on their merits.

8. As you know, I advocate the strict enforcement of Government contracts. If contracts are not going to be enforced there is no sense negotiating them. However, I recognize that you and other senior Defense officials have

responsibilities far broader than my own and that you may determine that, in order to facilitate national defense, the Navy must grant extra-contractual relief in accordance with Public Law 85-804. But even in that event, the Navy should establish the value of the shipbuilding claims. The Navy, the Congress, and the public should be able to find out just how much of the $544 million claimed by Electric Boat is valid.

10. In view of the above, I strongly recommend that you reassign the Electric Boat claims to the Navy Claims Settlement Board and allow that Board to finish evaluating them on their legal merits.

H. G. RICKOVER

Copy to:
Under Secretary of the Navy
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command
Chairman of the Navy Claims Settlement Board

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
6 Dec 1977

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY
(MANPOWER, RESERVE AFFAIRS & LOGISTICS)

Subj: Navy Claims Settlement Board

Ref: (a) My memo to you dtd 2 Dec 1977
(b) Your memo to me dtd 5 Dec 1977

1. In reference (a) I recommended that you allow the Navy Claims Settlement Board to finish evaluating the Electric Boat claims on their legal merits. I pointed out that to protect itself against inflated and exaggerated claims in the future the Navy should establish the value of the Electric Boat claims regardless of what other action the Navy may be considering, including the granting of extra-contractual relief in accordance with Public Law 85-804.

2. In reference (b) you stated that a decision has been made to undertake "separate discussions with Litton and Electric Boat toward the possible resolution of complex, long-standing problems" and that "It was the consensus of those directly interested in the foregoing decision, that sound organizational reasons dictated that Electric Boat claims should be withdrawn from the NCSB during the pendency of such discussions and awaiting their eventual outcome."

3. In view of the financial problems at Electric Boat and Litton it is unlikely they will accept a claim settlement on the merits of their claims because they would then have to report large losses to their stockholders. It would be to their advantage to contest the claims for many years through the courts and in Congress. In that way they can defer the reporting of losses and perhaps avoid them if they can convince someone in Government, as has happened in the past, to agree to a settlement for more than the claims are worth.

4. Because settlement in accordance with the terms of the contract is probably impossible at Electric Boat or at Litton, I can understand why Navy officials might wish to avoid a situation where both the Navy Claims Settlement Board and the Navy Secretariat are conducting settlement negotiations simultaneously with Electric Boat, but on different bases.

However, the Board should be allowed to complete its analysis of the Electric Boat claims to determine the amount legally owed by the Navy.

5. I do not question your decision to undertake discussions with Litton and Electric Boat in an effort to arrive at a permanent solution which would be in the Government's long-term interest. If may be possible to arrive at a settlement that would be in the Government's interest and still not undermine the basis of future Government contracts, either in the shipbuilding business or elsewhere in the defense industry. The following are some important considerations which I believe should be taken into account in an effort of this sort:

a. Attempts to reach an overall settlement of the shipbuilding claims should be done in such a manner as not to prejudice the Government's ability to enforce the terms and conditions of existing Government contracts. For example, in the previous effort to settle shipbuilder claims under PL 85-804, Navy and Defense officials tried to justify the granting of extra-contractual relief by making public statements to the effect that the escalation provisions of Navy shipbuilding contracts were unfair or inequitable. Although untrue, these statements have subsequently been used against the Navy in various judicial forums.

b. The settlement should constitute a one-time, permanent solution. Unless precautions are taken, simply "paying off" shipbuilders today will leave the Navy with similar problems tomorrow.

c. The settlement should not establish a precedent which the Navy could not, in principle, apply to other claims-troubled contractors who are essential to national defense and whose projected losses are sufficiently large that their continued ability to perform is in question.

d. The Government should try to get back, to the greatest extent possible, as much in value as it gives up.

e. The settlement should guarantee the future availability of facilities to the Navy well into the future--say 25-50 years, together with the contractual right to change contractors. In this way the Navy will not continue to be vulnerable to threats of work stoppage whenever a shipbuilder encounters financial problems. In this regard a Government-owned, Contractor-operated plant could offer considerable advantages.

6. It appears to me that it is a mistake to terminate the Navy Claims Settlement Board efforts to complete its analysis of the Electric Boat claims. This Board was established at the request of the Deputy Secretary of Defense specifically for the purpose of analyzing and, if possible, settling shipbuilding claims on their legal merits. It is my understanding that the Board was within a few weeks of completing their analysis and establishing how much the Board considered the Government legally owed on the $544 million Electric Boat claim. I understand also that the only outside information the Board needs to complete its analysis of the Electric Boat claim is the technical evaluations for thirteen claim items under my cognizance. The results of my technical evaluation have not yet been formalized in reports to the Board. However, nearly all of the analysis has already been performed, and I will be able to report my conclusions on these thirteen items shortly. With this information the Board should be able to arrive quickly at a final figure for the worth of the Electric Boat claim.

7. I am concerned that by now withdrawing the Electric Boat claim from the Board, the Navy may be subjecting itself to criticism in Congress and elsewhere. Regardless of the "organizational reasons" for the decision, termination of the claim evaluation effort at this late date will inevitably be viewed as a Navy effort to keep the Congress and the public from finding out what the Electric Boat claim is actually worth.

8. Even if the Navy proposed to grant extra-contractual relief to Electric Boat under Public Law 85-804, it will no doubt be asked by Congress to reconcile any final settlement with the true value of the Electric Boat claim, so that Congress will know the actual extent of the extra-contractual relief being proposed. In addition, terminating the Navy Claims Settlement Board evaluation effort of the Electric Boat claim would have the following undesirable effects:

a. It would discourage those who have been working hard to analyze the Electric Boat claim during the past year. They can only conclude that their efforts have been wasted. It will also set an undesirable precedent for others involved in claims matters.

b. If extra-contractual relief were recommended for Electric Boat without determining contractual responsibility for the half-billion dollar overruns the company has reported under its SSN 688 Class shipbuilding contracts, Congress and the public might be left with the impression that "Navy mismanagement" caused all of this problem as Electric Boat contends.

c. The lack of a firm Navy Claims Settlement Board figure as to the worth of the Electric Boat claim would tend to weaken the Government's hand during the independent discussions you plan to undertake with Electric Boat.

d. As I pointed out in reference (a), Newport News may well harden its position before the Navy Claims Settlement Board, thus making it increasingly unlikely that the Board can settle the Newport News claims on their merits.

9. For the above reasons, I again recommend that you allow the Navy Claims Settlement Board to complete its evaluation of the Electric Boat claims.

H. G. Rickover

Copy to:
Secretary of the Navy
Chief of Naval Operations
Under Secretary of the Navy
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command
Chairman of the Navy Claims Settlement Board

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

10 Apr 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Shipbuilding claims

Today, at Mr. Jayne's request, members of my staff and I met with Messrs. Cutter, Jayne, Sitrin, and Stubbing of the Office of Management and Budget to discuss shipbuilding claims. Attached are the notes I discussed and left with them.

H.G. Rickover

Attachment:
As stated

Copy to:
Deputy Secretary of Defense
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Chairman, Navy Claims Settlement Board

NEWPORT NEWS SHIPBUILDING CLAIMS AGAINST THE NAVY

1. To understand the unlikelihood of quickly negotiating a settlement of the remaining Newport News claims that is fair to the Government, it is important to keep the following facts in mind:

a. The remaining Newport News claims request an increase in contract ceiling prices of $742 million. If they were accepted at face value, Newport News would receive about $346 million. The Company has reported about $186 million as income from the claims through 1977. However, detailed Navy analysis of the claims reveals that they are actually worth far less than $186 million.

b. By booking a large income against the claims, Newport News has been able to report the highest profits in Newport News' history at the same time they are writing off major losses on commercial shipbuilding contracts.

(1) Newport News has never reported an overall loss in any year since it was acquired by Tenneco in 1968. In 1975 the Company reported a record high of $30 million profit before taxes; in 1976, $40.5 million; in 1977, $50 million.

(2) Even so, Newport News absorbed a loss through 1976 of over $35 million on three Liquefied Natural Gas carriers, the first ships being built in their new commercial yard. For 1977 the reported loss on these ships is expected to increase to $85 million or more.

(3) There is a marked difference in the way Newport News treats their commercial customers and the way they treat the Navy. They are absorbing major losses on commercial shipbuilding without submitting claims against their commercial customers and without complaining about the much less favorable escalation and cost-sharing provisions of their commercial contracts as compared to their Navy contracts. At the same time, they publicly complain about the "unfairness" of the Navy contracts and submit highly inflated claims against the Navy.

(4) Newport News could have booked a much lower income from the claims in 1976 and 1977 and still have shown a profit for Navy work. However, the Navy profit then might not have offset the commercial losses in those years, and might have required Newport News to report an overall loss in 1976 and/or 1977 because of the commercial loss. They chose instead to book a high value for the

ENCLOSURE(1)

claims and report record profits. To do otherwise would have focused more attention on the commercial shipbuilding losses. Obviously, Mr. Diesel would like to avoid that.

c. If Newport News were to accept the Navy's value for the claims and settle them in 1978, they would have to report as a loss in that year the difference between the income from claims previously booked and the settlement amount. This would almost certainly require them to report an overall loss for 1978, a step Mr. Diesel would be very reluctant to take.

d. Newport News has already been paid about $45 million in provisional payments against pending claims. These payments significantly reduce the additional cash they would receive by settling the claims at the Navy's estimate of their worth. On the other hand, by refusing to settle they can keep a high booked value for the claims for many years while they resort to the litigative process. Further, they can continue to press Navy and Defense officials, or the Armed Services Board of Contract Appeals (ASBCA), or the Court of Claims to settle the claims for a higher amount. As this dispute goes on over the years, if Newport News lowers its estimate of what they will ultimately recover, they can do so a little each year so as to offset the difference with other profits. Meanwhile they can quietly put their commercial shipbuilding losses behind them by using the booked income for the Navy claims to keep the reported overall profits high.

e. Mr. Diesel's letter of 22 December 1977 to the Navy Claims Settlement Board, in which he rejected the Navy's offer to settle the $90.4 million claim on the SSN 686/687 contract makes it clear that Newport News has no intention of settling the claims at their value as determined by the Navy. He officially asked for a Contracting Officer's decision on the SSN 686/687 contract and asked the Navy to give Newport News its offers for the other claims. The Contracting Officer decision issued on the SSN 686/687 claim was for $2.9 million. While the Navy's offer to settle was higher, it included amounts for litigative risk beyond the $2.9 million in actual entitlement.

f. Newport News has employed dubious techniques to inflate the claims. Specific examples of claims items which may constitute violations of fraud or false claims statutes have been reported by others as well as myself. These items have common features of misleading statements; omission of facts; statements that are demonstrably untrue; and so forth. Taken together, these items appear to have been carefully coordinated, thus raising the question of whether techniques were deliberately devised and used to distort the truth in such a way that fraudulent or false intent would be difficult to prove. This raises the

further question whether such coordination of the claims, if it were found to exist, would not itself violate applicable statutes. Whether or not Newport News claims violate fraud or false claims statutes cannot be determined until they are investigated by the Justice Department. Even then, it would take great effort and several years to carry through a successful prosecution of the case.

2. In his testimony to the Joint Economic Committee on 29 December 1977, the Assistant Secretary of the Navy (Manpower, Reserve Affairs, and Logistics) indicated that he intended to become personally involved in negotiation of the Newport News Shipbuilding claims which have been assigned to the Navy Claims Settlement Board, rather than let the Board carry out its charter. This testimony has been widely interpreted as a signal that if the Board cannot reach settlements with Newport News on the claims within the amounts the Board considers justifiable under the terms of the contracts, then the Navy Secretariat will take over the negotiations. The Secretariat appears to be following this course rather than allowing the Board to issue Contracting Officer decisions and letting the matter be resolved by the normal process before the ASBCA.

3. The only way the Secretariat can expect to settle the Newport News claims quickly is to offer them much more money than the Board considers justified, based on its review of the claims. Yet, it is unlikely that the Secretariat has achieved greater insight as to the merits of the claims than the Board. The invalid and inflated portions of the Newport News claims have increased the cost of the Navy's claims analysis by millions of dollars and have diverted scarce talent from important technical work. Further, the Navy's public reputation has been damaged by the adroit manipulation of the press by Company officials. If, under these circumstances the Secretariat increases claim settlement offers without resorting to P.L. 85-804, it would ratify the whole omnibus claims strategy Newport News has been following and encourage others to adopt the same strategy. There would then be no incentive for any Defense Department contractor henceforth to accept resolution of contract disputes by contracting authorities if he could bypass the litigative process and obtain a higher price at the Secretariat level.

4. Many professional Navy people, officers and civilians, have had to devote a great deal of their time away from their normal work to evaluate these claims. They are quite aware of the highly inflated nature of these claims. I have yet to meet anyone who has worked on the analysis of these claims who is not disturbed by their content. These people are deeply interested in how the Secretariat would determine and justify the additional amounts to be paid for these claims.

5. It is one thing for the Secretariat to review the quality of the work performed by Navy procurement officials, including the Navy Claims Settlement Board, and to take action to correct deficiencies found. It is entirely another matter, however, for the Secretariat to bypass the contractual process and undermine their subordinates. In this regard, the very purpose for establishing the ASBCA was to adjudicate contract disputes for the Secretary. It should be allowed to perform this function.

6. It is possible that the ASBCA would find that Newport News is contractually entitled to more than the Navy Claims Settlement Board considers the claims merit. However, to reach that conclusion the ASBCA would have to hear the arguments on both sides of each issue and render a formal decision which would then form a basis for evaluation of contract disputes in the future. This would at least provide a resolution of the issues raised in the claims. That course is far preferable to settling the claims on the basis of the amount the contractor has decided he wants to hold out for.

ELECTRIC BOAT SHIPBUILDING CLAIMS AGAINST THE NAVY

1. The Navy now has pending a $544 million claim by Electric Boat covering its two SSN 688 Class submarine ship construction contracts. The cost estimates used by General Dynamics for its 1977 annual report indicate that without any claim recovery, Electric Boat will lose $840 million on the two SSN 688 contracts.

2. The Navy's evaluation of Electric Boat's $544 million claim indicates that it is grossly inflated and far exceeds the amount the Navy legitimately owes. I have identified numerous items in the claim which should be investigated for possible violation of federal fraud and false claim statutes.

3. There is no reason to believe that General Dynamics will agree to settle their claim on its merits. By keeping large claims outstanding and threatening to submit even more claims, the company retains the flexibility to defer the reporting of losses; to hope for a settlement independent of the merits of the claims; or to write off losses gradually over future years as the dispute wends its way through the courts.

4. The Navy Secretariat has announced that it is exploring the possibility of a "total settlement" with General Dynamics that would dispose of the Electric Boat claim, presumably by granting extra-contractual relief under PL 85-804. I have also attached the criteria I believe should be met if shipbuilding claims are to be settled by providing extra-contractual relief. In addition, at Electric Boat the following is germane:

a. The Navy awarded both SSN 688 Class contracts to Electric Boat based on competitive bids; the first without negotiation of prices. If the Electric Boat contracts were now to be reformed under PL 85-804 to provide a higher price or more favorable terms, Newport News--the unsuccessful bidder in these competitions--would no doubt raise objections. Further, Newport News would probably demand extra-contractual relief on its SSN 688 ship construction contracts.

b. Electric Boat is spending $50 million more per submarine than its competitor, Newport News, to build identical SSN 688 Class ships to identical plans in essentially the same time frame. This indicates that, contrary to the allegations in the Electric Boat claim, the contractor's own inefficiency and poor productivity contributed substantially to the financial problems at Electric Boat.

ENCLOSURE(2)

c. There is a very real possibility that General Dynamics officials "bought in" on the SSN 688 contracts, and that this contributed to the large cost overruns. I believe that Electric Boat records will show that the proposed bid estimates prepared by Electric Boat shipyard personnel were substantially reduced by corporate officials in St. Louis prior to submission to the Navy.

d. Although corporate officials were aware of problems at Electric Boat for many years, they did little to correct them. For one and one-half years, the top management job at Electric Boat was held by a financial executive who had no prior shipbuilding experience.

e. The Electric Boat claim on its second SSN 688 submarine construction contract is based primarily on the alleged impact of late or defective Government-furnished drawings and allegations that the Government-furnished design was different than the company expected when it bid on the contracts. Yet, by the time that contract was awarded, Electric Boat had in hand nearly all Government-furnished drawings and had performed substantial construction work on the first contract.

5. For several years, General Dynamics officials seem to have gone to great lengths to avoid reporting projected losses on the SSN 688 contracts to their stockholders. Initially, they compensated for large overruns on the first SSN 688 Class ships by reducing their estimates to complete the follow ships. Eventually the overruns on the early ships became so large that this technique was no longer possible. Then the company started booking income against the large claims they submitted. In that way the company was able to continue to avoid reporting any losses on this program.

6. General Dynamics management has consistently miscalculated the extent of their own financial problems at Electric Boat such that if in prior years the Navy had paid everything the company asked, the company would still be facing potential losses of hundreds of millions of dollars on these two contracts. Specifically:

a. In March 1976, the Navy settled, for $97 million, a $230 million Electric Boat claim covering all items of Government responsibility through May 1975 on the first SSN 688 Class shipbuilding contract. At that time the Navy had to turn down a General Dynamics' offer for a claims release covering the second contract for an additional $53 million because General Dynamics had not yet submitted a claim on the second contract.

b. In May 1976, Deputy Secretary Clements offered to reform these two contracts under PL 85-804 to provide more liberal escalation payments in return for a complete claims release. Under this arrangement the company would have received about $170 million in addition to the $97 million settlement of the first SSN 688 claim. General Dynamics accepted the Clements' offer. However, Mr. Clements abandoned this scheme when Newport News and Litton refused to drop their claims on a similar basis. This tentative agreement with Electric Boat was never executed because Litton and Newport News rejected the Clements' offer. As late as November 1976, General Dynamics officials were still imploring the Navy to implement the Clements' 85-804 settlement. Had the Navy done so, the company would still face projected losses in the hundreds of millions of dollars.

c. In February 1977--only a few months after pursuing the $170 million Clements' settlement--Electric Boat raised its cost estimates on the SSN 688 Class contracts; the company reported a projected cost overrun of approximately $386 million. By November 1977, the company's projected overrun had grown to $545 million. Currently, the projected overrun is up to $840 million.

7. To my knowledge, General Dynamics has not submitted a formal request for extra-contractual relief. Further, I understand that financial audits by the Navy indicate that General Dynamics can absorb the losses being projected on the SSN 688 Class contracts. In these circumstances it would seem appropriate to let those in the Navy who have previously been charged with responsibility for evaluating and trying to settle these claims to continue to do so rather than having the Navy Secretariat take over these functions.

ELECTRIC BOAT's "35,000 CHANGES" ALLEGATION

There have been numerous accounts in the press recently regarding Electric Boat's allegation that cost overruns on their SSN 688 construction program are due largely to the Navy's having issued 35,000 "changes" to the submarines. This allegation is inaccurate and totally misleading. Here are the facts:

- About 6,000 drawings are required to build a SSN 688 Class submarine. To date, an average drawing has had five to six revisions issued to it. This amounts to over 30,000 drawing revisions, and is the apparent basis of the Electric Boat allegation.

- The average of 5 to 6 revisions per drawing on SSN 688's is in line with both military and commercial shipbuilding practice. For example, on the SSN 637 Class submarines designed by Electric Boat, the average drawing had about 5 revisions; the FFG, 7 revisions per drawing; the LHA and DD 963, an average range of 4 to 7 revisions per drawing; and two classes of tankers designed by a private builder for commercial customers had averages of 5.7 and 6.7 revisions per drawing.

- The vast majority of drawing revisions do not involve "changes" to the scope of work agreed to by the parties and defined in the contracts.

  For example, many thousands of drawing revisions merely correct editorial errors. Many other revisions are made at the request of the shipbuilder for his own convenience. Also, a large number of revisions are issued before work begins and do not increase costs of construction. In fact, many revisions are issued which decrease the shipbuilder's costs.

- Of course, some revisions require ripout or refabrication of previously completed work, or require work beyond that defined by the contract. In these cases, a contract change is necessary, and the shipbuilder is contractually required to promptly notify the Government of such changes so that they can be quickly negotiated and the contract amended to pay the shipbuilder for his increased effort.

ENCLOSURE(3)

- To date, the Navy has issued 3,350 changes to the 18 SSN 588 submarines under contract at Electric Boat. Of these, 2,795--over 80%--have been fully adjudicated by mutual agreement between the Navy and Electric Boat for a total increase in contract price of about $37 million. This is less than 3% of the contract price.

- The remaining 20% of changes have not been adjudicated. However, based on actual return costs for the work required by these changes, the Navy expects that the total for all 3,350 changes--both those negotiated and those as yet unadjudicated--will be less than 5% of the contract price. This is consistent with past practice because, historically, the cost of all changes on Navy combatant ships during the life of the contract has been about 5% of the contract price.

- There is a simple way of showing the Electric Boat allegation is totally erroneous. Newport News and Electric Boat are building SSN 688 Class submarines to the same design, with the same drawing revisions, and with the same changes. Yet the SSN 688 Class submarines being built at Electric Boat are costing about $50 million more per submarine, than at Newport News. The only possible explanation is that Electric Boat is less efficient than Newport News.

RECOMMENDATIONS CONCERNING USE OF PUBLIC LAW 85-804

The following considerations should be taken into account in the event that senior Defense officials determine that a negotiated settlement of shipbuilding claims independent of the merits of the claims is necessary:

- Attempts to reach an overall settlement of the shipbuilding claims should be done in such a manner as not to impair the Government's ability to enforce the terms and conditions of existing Government contracts. In the previous effort to settle shipbuilder claims under P.L. 85-804, Navy and Defense officials tried to justify the granting of extra-contractual relief by making public statements to the effect that the escalation provisions of Navy shipbuilding contract were unfair or inequitable. Although untrue, these statements have repeatedly surfaced and have even been used against the Navy in various judicial forums.

- The settlement should constitute a one-time permanent solution. Unless precautions are taken, simply "paying off" shipbuilders today will leave the Navy with similar problems tomorrow.

- The settlement should not establish a precedent which the Navy could not, in principle, apply to other claims-troubled contractors who are essential to national defense and whose projected losses are sufficiently large that their continued ability to perform is in jeopardy. In the previous attempt to settle claims under P.L. 85-804 with four specific shipbuilders, other defense contractors expressed an interest in receiving the same deal.

- The settlement should not permit shipbuilders to bail out their subcontractors at Government expense.

- The settlement should be a two-way street. The Government should make a concerted effort to get back as much in value as it gives up. This will help protect the taxpayer's interests and tend to discourage other contractors from seeking extra-contractual relief.

ENCLOSURE(4)

- The settlement should guarantee the future availability of facilities to the Navy 25 to 50 years into the future together with the contractual right to change contractors. This would protect the Navy from threats of work stoppage whenever a shipbuilder encounters financial problems. In this regard, a Government-owned, contractor-operated plant could offer considerable advantages.

- The granting of extra-contractual relief should not excuse a contractor from any legal liability he might have under federal fraud or false claims statutes. Similarly, the granting of extra-contractual relief should not be done in a way which prejudices the Government's ability to enforce such statutes. These statutes should be strictly enforced.

- The true financial condition of the corporation should be ascertained by Government audit. Corporate officials sometimes tend to exaggerate their financial problems, especially in dealing with Government officials. In this regard, it is worth noting that the conglomerate parents of the Navy's three largest shipbuilders are still reporting profits in spite of the financial problems at their shipyards.

- The worth of the claims should be determined. The Navy, the Congress, and the public have a right to know just how much of the amount claimed is valid and also the value of the extra-contractual relief which is granted.

GOVERNMENT-OWNED, CONTRACTOR-OPERATED PLANTS

- If the Navy, under threat of not being able to get Navy ships, is unable to enforce its contracts with private shipbuilders and has to reprice them regardless of legal merits, the Government should face up to this fact and take steps to protect itself.

- The Government can assure its future access to a shipyard's production facilities by buying the shipyard and operating it as a Government-owned, contractor-operated (GOCO) facility. Under this arrangement:

  The Government owns all land and facilities.

  The private contractor is paid a small fee to operate the facility under a cost reimbursement contract with the Government.

  The contractor is responsible for managing the work, providing personnel, organizing the plant, etc.--subject to review and approval by the Government.

  If the contractor does not perform well, the Government would have the right to replace him with another contractor to operate the facility.

- While a GOCO shipyard is not a panacea for current shipbuilding contract problems, it would guarantee the Navy access to the facilities and put an end to the claims business--allowing both Navy and shipbuilder personnel to concentrate on the difficult task of building ships.

- The Government-owned, contractor-operated plant approach should only be used in cases where the Government decides it must give extra-contractual relief to an essential shipbuilder. Moreover, the Government should pay fair value for any shipyard it would acquire under these circumstances as part of the overall settlement, so that the Government would not in any sense be confiscating private property.

- Alternatively, the Navy might leave the shipyard under private ownership, but build ships under a cost-reimbursement operating contract which would guarantee the shipbuilder a modest fee. In such an arrangement, however, the Government should obtain the unilateral right to cause the company to lease the shipyard to a third party of the Government's choosing so that the Navy would have protection against companies who refuse to honor contracts or who would deny facilities essential for Navy work.

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
26 Apr 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Proposed $31 million payment to Ingalls Shipbuilding Division of Litton Industries on "Project X" decision (Armed Services Board of Contract Appeals decision Number 17579)

1. On February 17, 1978, the Armed Services Board of Contract Appeals (ASBCA) awarded Litton Systems, Incorporated $50.4 million on the $131.5 million "Project X" claim submitted under three submarine construction contracts. The claim covered increased costs allegedly incurred in construction of 14 commercial and five Navy surface ships built during the 1960's. I understand that the Navy has requested the ASBCA to reconsider portions of the decision; but in the interim is planning to pay $31 million to Litton for those portions of the decision not covered by the Navy's motion for reconsideration.

2. The ASBCA decision includes items which could have far reaching implications. Among these are the following:

a. The Board has ordered the Navy to pay costs incurred on commercial ships because of contract changes issued under Government contracts.

b. The Board allowed claims on items for which the company had previously granted the Navy a claims release.

c. The Board evaded the Court of Claims prohibition against the payment of interest by awarding Litton $9.8 million as "profit for use of capital."

3. I understand that the Navy has asked the Board to reconsider its decision. But in so doing, the Navy did not challenge at least two important items: the invalidation of the claims release language, and the concept of charging the Navy for costs incurred on commercial work. These are precedents which could cost the Government hundreds of millions of dollars in future claims.

4. I realize that asking the ASBCA to reconsider a decision is largely ceremonial. To my knowledge the Board has never reversed itself on a major finding. This problem is compounded by the Defense Department's historical unwillingness to exercise its rights to appeal ASBCA decisions. The Defense Department contends that the Board is the Secretary's representative and thus the Secretary should not be in the position of appealing his representative's decisions. The Defense Department has held this position despite the Department of Justice view that Government agencies have the right to appeal from decisions rendered by their own Boards of Contract Appeals.

5. One of the great weaknesses of our present system of contract administration and dispute resolution is that the Board has become the final word as to the Government's rights under Government contracts. Moreover, the Board appears to be exercising power and authority far above that which has been accorded to the Secretary of Defense. I doubt that the Secretary of Defense could have authorized a $50 million payment to Litton under these circumstances without use of PL 85-804. Yet, the Board apparently does not consider itself so constrained. Under these circumstances, if poor decisions are not subject to review and reversal the Board effectively assumes in contract matters the power of the Supreme Court.

6. Because of the importance of the Litton decision and its potential impact on all Government contracts, I recommend that the Navy request the ASBCA to reconsider the other important elements of the Litton decision. Moreover, if the Board holds to its original decision, the Navy should then request the Department of Justice to appeal the Board's decision to the Court of Claims where precedent-setting decisions are subject to review by appellate courts. Until the legal principles established in the "Project X" decision are tested in court, I recommend that the Navy make no payments against the ASBCA's decision.

7. I would appreciate being informed of what action you decide to take in this matter.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Manpower, Reserve Affairs & Logistics)
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

8 MAY 1979

MEMORANDUM FOR THE DEPUTY SECRETARY OF DEFENSE

Subj: Government's Right of Appeal from Adverse Board of Contract Appeals Decisions

1. The purpose of this memorandum is to request that you endorse on behalf of the Defense Department proposed legislation which spells out the Government's right to appeal adverse decisions by agency boards of contract appeals, including the Armed Services Board of Contract Appeals (ASBCA). The paragraphs which follow explain the pertinent background and why I believe you should support this important Government right.

2. For many years defense contractors, their lobbyists, and others have argued that the Government does not have the right to appeal adverse rulings by the ASBCA. The Department of Justice has taken the position the Government in fact has this right of appeal but, to date, the matter has not been tested in court.

3. In the Fiscal Year 1977 Authorization Bill (H.R. 12438), The House Armed Services Committee incorporated specific language providing that the Department of Defense has the same rights of appeal that contractors have. However, the Office of Management and Budget, speaking for the Administration and for the Department of Defense, opposed this legislation; the Senate deleted the language from the bill.

4. Subsequently, members of Congress such as Senators Chiles and Packwood, Congressman Harris, Kindness, Rodino, and Fisher have each introduced a bill involving the Government's right of appeal from agency boards of contract appeals, including the ASBCA. Currently two bills, S. 2787 sponsored by Senator Chiles and H.R. 11002 co-sponsored by Congressmen Harris and Kindness, are receiving the most attention. Both bills would give the Government the right of appeal.

5. The Department of Defense has been asked to comment on some of these bills. The Navy and the other services, I am told, endorse the right of Government to appeal decisions of a board of contract appeals. The Commission on Government Procurement, the Comptroller General, the ASBCA Chairman, and the Department of Justice have all endorsed this right. But within the Department of Defense I understand that the Office of the Secretary of Defense (OSD) procurement staff opposes the right of Government appeal and has relented only for cases:

> "...when the head of the agency determines, and the Attorney General concurs, that the decision of the agency board is egregiously erroneous as a matter of law." (underscoring added)

6. One of the great weaknesses of our present system of contract administration and disputes resolution is that without the Government having the right to appeal, the ASBCA, an administrative board, effectively has the final word as to the Government's rights under defense contracts, at least when the decision is against the Government. This is unheard of elsewhere in the system of jurisprudence in this country where decisions by Federal judges are subject to review by appellate courts which in turn are subject to review by the Supreme Court. But when it comes to a dispute under a defense contract, the ASBCA can try the facts, decide the law, and avoid further review by ruling against the Government. Since no judicial officer likes to be overruled, this creates an incentive to rule against the Government. To be consistent with our Governmental system of checks and balances, such unlimited authority should not be vested in an administrative board within an Executive Branch Department.

7. The Board appears to be exercising power and authority far beyond that vested in the Secretary of Defense himself. The Board's 1975 decision in the Lockheed case stands out as a vivid example. The contractor submitted a $159.8 million claim which the Navy, upon review, determined it owed $6.8 million. Without considering the merits of the claim, the Board awarded Lockheed $62.0 million. The Board did this on the strength of statements to the company's bankers by the Deputy Secretary of Defense to the effect that the Government would pay Lockheed that amount.

8. The Deputy Secretary would have been legally barred from making such a settlement on his own without exercising his powers to grant extra-contractual relief under P.L. 85-804, subject to the safeguards and Congressional reviews required thereby. However, the ASBCA, an administrative board which derives its authority from the Defense Secretariat, was able to achieve what a Secretary of Defense could not. Where else in the Government can a subordinate board arrogate to itself more authority than Congress gave its superiors?

9. The Board's recent decision in the Litton "Project X" case has even more far-reaching implications than the Lockheed decision. In this case the Board awarded Litton $50.4 million of $131.5 million claimed and in the process set new legal precedents. For example, the Board:

- Ordered the Navy to pay costs incurred on commercial ships because of contract changes issued under Government contracts.

- Allowed claims on items for which the company had previously granted the Navy claims releases.

- Evaded the Court of Claims prohibition against the payment of interest by awarding Litton $9.8 million as "profit for use of capital."

The Navy has requested the Board to reconsider portions of its decision; but this is largely a ceremonial function. To my knowledge, the Board has never reversed itself on an issue of substance.

10. Contractors, citing the Board's decision in the "Project X" case as precedent, will no doubt submit new claims for costs incurred on commercial contracts, for items previously covered by claims releases, and for interest. In evaluating these claims, defense personnel will then be expected to allow amounts for these items on the basis of the "Project X" precedent.

11. The Department of Justice has taken the position that the Defense Department already has the right to appeal from ASBCA decisions. On this basis, I have recommended to the Secretary of the Navy that he appeal the "Project X" decision and withhold payments on the Board's decision until the legal principles established therein have been tested in court. The Navy should also appeal the Lockheed decision unless by its inaction it is now barred by the statute of limitations.

12. Defense contractors like the present situation because they enjoy the upper hand. An unfavorable Board decision is not binding on them, but a favorable decision from the Board is as binding on the Government as if it came from the Supreme Court. To protect this advantage, defense contractors contend that since the ASBCA is the Secretary's representative, appealing an ASBCA decision is tantamount to the Secretary appealing his own decision. The Commission on Government Procurement effectively answered this argument in its report. The Commission pointed out that the boards of contract appeals actually function as quasi-judicial bodies and not as representatives of their agencies, since the agencies are contesting the contractors' entitlement to relief. The Commission said:

> "In this context, the Government should have an equal right of judicial review, since it would be an anomaly in the American judicial system for such formalized trial tribunals to have the final authority on decisions that set important precedents in procurement law."

13. I have heard that the OSD staff might be resisting the right of Government appeal so as to protect the Secretariat from having to decide what cases should be appealed. I believe this is the wrong way to look at this issue. Government appeal of adverse decisions will greatly enhance the ability of Defense and other Government officials to protect the public interest.

14. In view of the above, I recommend that you:

a. Endorse in the name of the Defense Department legislation giving the Government the right to appeal adverse board of contract appeals decisions.

b. Test the Department of Justice theory that the Defense Department already has this right by asking the Justice Department to appeal the Litton "Project X" and the Lockheed cases to the Court of Claims.

15. I would appreciate being informed of the action you take in this matter.

H. G. Rickover

Copy to:
Secretary of the Navy
Assistant Secretary of the Navy
(Manpower, Reserve Affairs & Logistics)
Chief of Naval Operations
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
9 May 1978

MEMORANDUM FOR THE DEPUTY UNDER SECRETARY OF DEFENSE FOR ACQUISITION POLICY

Subj: Government-owned, contractor-operated shipyards

Encl: (1) Recommendations concerning use of PL 85-804

1. On 9 March 1978, during our discussion of the shipbuilding contract claims problem, you suggested that I elaborate on the concept of converting some of our private shipyards to Government-owned, contractor-operated (GOCO) plants if the Navy ends up having to pay off shipbuilders under PL 85-804 in order to get the ships it needs. This memorandum responds to your request.

2. I have repeatedly testified to Congress and told my superiors in the Executive Branch that in my opinion the Navy should take whatever steps are necessary to enforce its contracts. I am still of this opinion today. However, I have also pointed out that my superiors have the authority to settle the shipbuilding claims under PL 85-804 independent of their merits if they determine it is in the national interest to do so. In such cases, I have recommended that any settlement of the shipbuilding claims independent of their merits take certain factors into account to avoid establishing precedents which could destroy the methods by which the Defense Department acquires necessary supplies. Enclosure (1) lists these considerations.

3. If the Navy must resort to granting extra-contractual relief under Public Law 85-804 under threat of work stoppage or future exclusion from the shipyard, it should at the same time ensure the availability of the shipbuilder's facilities to the Navy well into the future. In addition, if the Navy is forced to pay a shipbuilder's costs regardless of contractual responsibility under fixed-price type contracts, it should have some say in how the money is spent. One way to accomplish this would be for the Navy to buy the shipyard as part of an overall claim settlement and have a contractor operate the shipyard on a cost reimbursement basis as a Government-owned, contractor-operated (GOCO) shipyard.

4. The GOCO shipyard arrangement, as I envision it, would contain the following key features:

a. The Government would own or otherwise control all land and facilities.

b. Instead of negotiating and awarding individual contracts for each job, there would be a basic long-term operating contract to operate the facility on a cost reimbursement basis and perform whatever work the Government assigns. The contractor would be paid a fee for operating the facility. While the fee should be low as a percentage of sales, the return on investment would be high as the Government would own the facilities.

c. All financing costs would be borne by the Government under a letter of credit arrangement with the Treasury Department. This would eliminate any financing costs on the part of the operating contractor while at the same time eliminating any possibility of the contractor getting interest-free use of Government funds.

d. A reduced allocation of home-office general and administrative expenses would be negotiated with the contractor to reflect the reduced contribution of these services to a Government-owned, contractor-operated plant.

e. The contractor would not be allowed to take on commercial work, except in cases where specifically authorized by the Government.

f. The contractor would be responsible for managing the work, providing personnel, organizing the plant, etc., subject to review and approval by the Government.

g. The Government would retain the right to replace the operating contractor in the event of unsatisfactory performance.

Under this concept, the shipbuilders could get the guaranteed profits they want; the Navy would be assured of a continued source of supply for its warships; and the claims business would end--allowing both Navy and shipbuilder personnel to concentrate on the difficult task of building ships.

5. The concept of a GOCO facility is neither novel nor untried. The Department of Energy and its preceding agencies (Energy Research and Development Administration and Atomic Energy Commission) have successfully operated for over 30 years numerous large facilities in a manner similar to what I outlined above. In addition, the Department of Defense currently

has 80 facilities owned in whole or in part by the Government and operated by contractors. While the Defense Department calls these facilities GOCO plants, they differ from what I recommend for shipyards.

6. Many of the Defense Department plants have Government and contractor-owned assets intermingled such that the plant cannot be operated properly without the consent and participation of both the Government and the contractor. This commingling of assets prevents the Government from changing plant contractors in the event of unsatisfactory management, even if the contractor's investment is small. This enables the contractor to use the plant for as long as he wishes and to deny use of the plant to any competitor. For example, the plant where the F-4 and F-15 fighters are produced is a commingled facility with the contractor having a lease on the Government's assets until 1999. In addition, there is an Air Force plant producing jet engines where the contractor owns the boiler house and power distribution system.

7. The existing Department of Defense GOCO facilities contribute substantially to defense needs. In FY 1978 alone, over $3 billion was appropriated for programs conducted primarily in Department of Defense GOCO facilities. Among these programs in FY 1978 and recent years were major aircraft (F-14, F-15 and F-16 fighters; and A-6 and A-7 attack aircraft), major missiles (Minuteman, Poseidon, and Trident), tanks (M-60 and XM-1) and many types of munitions.

8. The concept of Government-owned, contractor-operated shipyards is not a panacea for the present shipbuilding contract problems--but neither is a resolution which would leave the Defense Department vulnerable to future demands for extra-contractual relief. There is little financial incentive for efficiency in fixed priced shipbuilding contracts that the Government is either unwilling or unable to enforce. Further, the Navy would not be upholding the taxpayer's interests if it granted extra-contractual relief and then continued to contract as before.

9. If, in fact, the Navy is considering some overall settlement with certain shipbuilders, but for political considerations wishes to avoid conversion of privately owned shipyards to Government-owned, contractor-operated plants, alternative means are available to achieve the same ends. For example, the Navy might leave the shipyard under private ownership but obtain the unilateral right to cause the company to lease the shipyard to any third party of the Government's choosing. In

that way the Navy would have much needed protection against companies which provide unsatisfactory management, refuse to honor contracts, or attempt to deny facilities essential for Navy shipbuilding work. Under this arrangement, the facilities would not be Government-owned. The responsibility for acquiring facilities, managing labor problems, and the like would remain with the contractor subject, of course, to the supervision that the Government must maintain under a cost reimbursement operating contract. Alternatively, the Government could lease the shipyard facilities on a long-term basis, and sublet the facility to an operating contractor.

10. I believe the Government should enforce its contractual rights. On the other hand, I recognize that practical problems exist in enforcing the shipbuilding contracts today. I also understand the desirability of settling the shipbuilding contract problems once and for all. However, any settlement should be done in a way that will not undermine other defense contracts and which would leave us with a satisfactory basis for conducting business in the future. In this regard I believe that if the Navy is unwilling or unable to enforce its fixed priced shipbuilding contracts with key shipyards, then operating them as Government-owned or leased, contractor-operated plants is the only viable long range solution to the problem.

11. I would appreciate being informed of what action you take in this matter.

H. G. Rickover

Copy to:
Deputy Secretary of Defense
Secretary of the Navy
Assistant Secretary of the Navy (Manpower, Reserve Affairs and Logistics)
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
12 May 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Government's right of appeal from adverse Board of Contract Appeals decisions

Ref: (a) My memorandum for you, subj: Proposed $31 million payment to Ingalls Shipbuilding Division of Litton Industries on "Project X" decision (Armed Services Board of Contract Appeals decision No. 17579) dtd 26 Apr 1978
(b) My memorandum for the Deputy Secretary of Defense, subj: Government's right of appeal from adverse Board of Contract Appeals decisions dtd 3 May 1978
(c) Your memorandum for Deputy Secretary of Defense dtd 4 May 1978

1. By reference (a) I recommended to you that if the Armed Services Board of Contract Appeals (ASBCA) affirmed its opinion in the Litton "Project X" dispute (ASBCA No. 17579), the Navy should request the Department of Justice to appeal the Board's decision to the Court of Claims, and should make no payments until the legal principles had been tested in court. In reference (b) I recommended to the Deputy Secretary of Defense that both the Litton decision and the Lockheed decision (ASBCA No. 18560), should be appealed.

2. At our meeting on 8 May, I pointed out that, in my opinion, the courts would not uphold the Board's decisions in these cases. You gave me an unsigned copy of reference (c) which your legal staff apparently prepared for your signature.

3. Reference (c) concludes that the Litton decision and the Lockheed decision should not be appealed. To support this conclusion, reference (c) states:

a. "The standard Navy contract disputes clause dating from January 1960 (and earlier) provides that . . . 'the decision of the Secretary or his duly authorized representative shall be final and conclusive to the extent permitted by United States law.' Decisions by the Secretary on questions of law are not binding on the contractor."

b. ". . . the plain language of ASPR Section 1-314(h), . . ., together with the rationale of the Supreme Court's opinion in the S&E Contractors case, makes it very dubious whether the Secretary himself can either disregard or seek court review of an ASBCA decision."

From ASPR 1-314(h), reference (c) quotes and underscores the following:

"'(h). Decisions of the Armed Services Board of Contract Appeals constitute decisions of the Head of the Department as referenced in the Disputes clause standard in all Government contracts. It is expected that decisions favorable to the appellant in whole or in part will be promptly implemented by payment at the contracting officer level.' (emphasis added)"

c. "In any event, I think it would be unwise as well as unfair to the contractor and arbitrary in the extreme for the Secretary to attempt to do so [seek court review of an adverse ASBCA decision] in the absence of fraud or the equivalent. The Government is under an obligation to deal fairly and in good faith with its contractors if it is to expect such treatment in return, and I intend to the best of my ability to act accordingly."

4. You have now signed reference (c) and payment to Litton has been released. However, the issue of the right of Government appeal from ASBCA decisions still is under consideration by the Deputy Secretary of Defense in connection with recent legislative proposals. In reference (b), I urged him to support the right of Government appeal. Since your recommendation to him takes a contrary position, I believe it is important that I inform both of you of my thoughts on reference (c). These are:

a. Reference (c) quotes language attributed to the standard Navy contract Disputes clause (see paragraph 3.a above). The language quoted is prescribed solely for use in procurements to be performed outside the United States and

its possessions. The equivalent language actually used in Defense contracts for work performed in this country is as follows:

> "The decision of the Secretary or his duly authorized representative for the determination of such appeals shall be final and conclusive unless determined by a court of competent jurisdiction to have been fraudulent, or capricious, or arbitrary, or so grossly erroneous as necessarily to imply bad faith, or not supported by substantial evidence."

The important point is that the standard Disputes clause does not set a different standard between the Government and a contractor with respect to finality of Secretarial or ASBCA decisions in contract disputes. Nowhere in the clause does it say or imply that an ASBCA decision is more binding on the Government than on the contractor; or, that the Government has a lesser right of appeal. Yet senior Defense officials and Navy attorneys have been operating as if contractors have a right of appeal, and the Government does not.

b. The standard contract Disputes clause actually used in Navy shipbuilding contracts contains an important provision which reference (c) does not mention. Specifically, paragraph (b) of that clause states:

> "(b) This 'Disputes' clause does not preclude consideration of law questions in connection with decisions provided for in paragraph (a) above; provided, that nothing in this contract shall be construed as making final the decision of any administrative official, representative, or board on a question of law." (emphasis added)

c. Reference (c) states: "Decisions by the Secretary on questions of law are not binding on the contractor." It fails to mention that such decisions are not binding on the Government either. In fact, it would be illegal for the Government to give away that right. The Wunderlich Act specifically states:

> "No Government contract shall contain a provision making final on a question of law the decision of any administrative official, representative, or board."

In its Litton and Lockheed decisions the Board effectively made new law. For example, the Litton decision ignores the statutory bar to payment of interest by re-labeling interest as "profit for use of capital." These decisions should be appealable on the simple basis that questions of law are involved.

d. Even if the Litton and Lockheed decisions were not appealable on the basis that they involve questions of law, I believe that they could be appealed if the head of the agency disavowed the Board decisions. Reference (c) suggests that the Supreme Court's decision in the S&E Contractors case precludes Navy appeal of ASBCA decisions. Reference (c) notes, however, that the Justice Department, which tried this case, firmly believes the S&E decision constitutes no such bar. On the contrary, the Justice Department considers that the S&E decision only precludes outside agencies such as the General Accounting Office and the Justice Department from appealing the finding of an agency board but does not prevent an appeal by the head of the agency involved. The S&E dispute arose on one of my Atomic Energy Commission contracts. Based on my knowledge of the case, I agree with the Justice Department opinion and believe that the Department should be asked to appeal the Litton and Lockheed cases as a test.

e. Reference (c) states that ASPR 1-314(h) (see paragraph 3(c) above) makes it very dubious whether the Secretary himself can either disregard or seek court review of an ASBCA decision. However, this provision of ASPR only says that ASBCA decisions constitute "decisions of the Head of the Department as referenced in the Disputes clause standard in all Government contracts" and that contracting officers are expected to implement such decisions by paying promptly. I see nothing in this ASPR provision that would in any way limit the Government's appeal rights under the Disputes clause or the Wunderlich Act. As I noted above, the standard Disputes clause does not say or imply that an ASBCA decision is more binding on the Government than on the contractor or that the Government has a lesser right of appeal. The Wunderlich Act protects the Government's right of appeal on questions of law.

The parties to a dispute frequently make payments subject to reservation of rights. Therefore, while ASPR 1-314(h) clearly encourages contracting officers to make prompt payments after ASBCA decisions favorable to contractors, it does not require it. Moreover, even if the Government makes payments against an ASBCA decision, it does not necessarily have to relinquish its rights of appeal.

f. Reference (c) implies that by appealing the Litton and Lockheed decisions, the Government would be dealing unfairly with the contractors. I disagree. These are not small businesses disputing questions of fact. The contractors are giant conglomerates expounding innovative new theories of law. If sustained, the Board's findings in these cases could have a major impact on Naval shipbuilding. To permit an administrative Board to have the final word as to the Government's rights in these new areas of law is unfair to the taxpayers.

g. Reference (c) suggests that an appeal by the Government of the Litton decision "could reopen all or a part of the original $131 million controversy as well as initiate a whole new and extended litigation of what is already a considerably aged controversy." I am advised that by law contractors have six years after the date of an ASBCA decision in which to appeal to the Court of Claims. Thus, they could reopen the controversy whether or not the Government appeals.

5. There is precedent for withholding payment when the ASBCA appears to have exceeded its authority. A short time after he assumed office, I met Assistant Secretary of the Navy Hidalgo. He said that, as General Counsel of the U.S. Information Agency (USIA), he joined with the Office of the Navy General Counsel in trying the Fischbach & Moore case (ASBCA No. 18146).

6. As I understand it, Mr. Hidalgo disagreed with the Board's decision with respect to interest costs. Mr. Hidalgo apparently recommended that USIA refuse to make payment on the ASBCA decision. In this way, the contractor, if he wanted to pursue the matter further would have to take his case to the Court of Claims where the Government would be able to test the legality of the Board's ruling. I understand that to date the USIA has not released payment on the ASBCA decision nor has the company appealed to the Court of Claims.

7. With respect to the release of payments to Lockheed, reference (c) states:

> ". . . $131 million was withheld because of the pendency before the Department of Justice of a possible civil fraud action claim. We have now been informed by the Justice Department by letter, that it has completed its review and closed the matter with a determination that no civil fraud litigation is warranted. Thus, this is no longer a valid reason for withholding payment." (emphasis added)

My understanding is that, from the outset, the Department of Justice has been conducting a criminal fraud investigation of the Lockheed claim and that this investigation is still underway. It seems illogical to me that the Navy, after withholding payment to Lockheed for several years because of potential civil fraud, would now release payment with the criminal fraud investigation outstanding.

8. It is also interesting to note the parallel between the actions of Lockheed and Fischbach & Moore when the Government has withheld payment. In both cases, the contractors could have asked the Court of Claims to order the Government to release the funds. I understand that to date neither company has elected to do so. If they did they would lay open for judicial review the favorable decision they received from the ASBCA. Apparently Lockheed concluded it was better to suffer the $13 million withholding than to risk a Court of Claims reversal of the entire $62 million ASBCA decision--particularly when the Navy assessed the true value of the claim at only $7 million.

9. I recommend that in the Litton and Lockheed cases the Navy try to assert its right to appeal, while at the same time withholding payment on the items in question, as the USIA has done in the Fischbach & Moore case. In addition, I reiterate my recommendation that the Navy and the Defense Department support current legislative efforts to reaffirm the right of the Government appeal of ASBCA decisions.

H. G. Rickover

Copy to:
Deputy Secretary of Defense
Assistant Secretary of the Navy
(Manpower, Reserve Affairs & Logistics)
Chief of Naval Operations
General Counsel of the Navy
Chief of Naval Material
Chairman, Navy Claims Settlement Board
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

16 JUN 1978

MEMORANDUM FOR THE CHIEF OF NAVAL OPERATIONS

Subj: Comments on Proposed PL85-804 Settlement of General Dynamics Claims at Electric Boat

Encl: (1) My notes for discussion with Secretary Claytor dated 6/15/78

1. On June 15, 1978, I accompanied Secretary of the Navy Claytor on a tour of the Naval Reactors Facility in Idaho Falls, Idaho.

2. I gave him a copy of enclosure (1).

H. G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Sea Systems Command
Chairman, Navy Claims Settlement Board

On June 15, 1978, I delivered the
notes to Secretary of the Navy Cl
during his tour of the Naval Reac
Facility in Idaho Falls, Idaho.

H. G. Rickover

June 15, 1978

Notes for Discussion With Secretary Claytor

Subject: COMMENTS ON PROPOSED PL85-804 SETTLEMENT OF GENERAL DYNAMICS CLAIMS AT ELECTRIC BOAT

1. I have read the Aide Memoire reflecting the agreement between the Navy and General Dynamics for a PL85-804 settlement of the Electric Boat claim. I understand that some of the details as to how the agreement will be implemented are still being worked out.

2. As I understand the general financial aspects of the proposed arrangement, the Government will end up paying:

   a) The maximum value the Navy claim settlement board assigned to the $544 mill dollar Electric Boat claim ($125 million including litigative risk and litigati cost);

   b) An additional $359 million as a 50/50 sharing of presently estimated cost overruns beyond what the Navy contractually owes;

   c) All escalation costs in excess of 7% for labor and 6% for material througho the remaining life of the contract. In this regard, I note that, until shortly before the settlement was announced, Electric Boat cost reports reflected a much higher projected escalation rate which, if accurate, would result in the Government absorbing an extra $140 million or so above the amount spelled out in the agreement.

   General Dynamics has agreed to absorb $359 million of otherwise allowable costs.

3. What concerns me most is where the proposed agreement, regardless of amount, leaves the Navy with respect to conducting future business. As you know, Electric Boat wil not deliver the last ship under this contract for at least six years. The Trident program extends far beyond that. Unless special precautions are taken, the company might very well attempt, several years from now, to recover all or a portion of the $359 million they are presently agreeing to absorb by claiming that events subsequen to the June 9, 1978 claims release caused increased cost at the shipyard. If such claims materialize in a similar form to those we have encountered to date, the Navy will have gained little from the proposed settlement.

4. In the early 1970's the Navy started inserting in its contracts the so called "anti-claims" changes clauses. General Dynamics signed these contracts acknowledging the requirement to identify promptly any cases of alleged constructive changes so that they could be settled as they arose. The contracts specifically bar claims for constructive changes which are not promptly identified. The Navy implemented these clauses to preclude large, after the fact claims of the type General Dynamics has submitted. With respect to the Electric Boat claim, Navy personnel have had to review records extending back for five or six years, reconstruct the circumstances existing at that time, and waste countless hours evaluating and documenting erroneous and inflated claim items.

5. The Navy for many years took technical action on contracts or submittals in reliance on written assurances that the action would not involve a contract change. Yet, the company later submitted claims covering the same item.

6. The company has refused to abide with the terms of the so called "Overhead Agreement" it signed with the Navy. Just as in the proposed claim settlement, the company agreed to absorb otherwise allowable costs if these costs exceeded a certain level. Under this agreement, I understand the Government is entitled to a refund of about $30 million. That dispute is unresolved.

7. Productivity at the shipyard has not improved. I suspect there will be further slippage on later ships because Electric Boat is giving priority to the earlier ones. Costs at Electric Boat are still running $50 million more per ship than at Newport News for a comparable ship built in the same time frame.

8. Electric Boat delivery schedules have typically been overly optimistic. While the Navy needs ships at the earliest date, there is little assurance that Electric Boat will be able to deliver all these ships in accordance with its latest schedules. If the company's latest delivery projections are accepted as contract delivery dates, the company might later contend in claims that Government action subsequent to June 9, 1978, are responsible for the delay.

9. In my opinion, the above issues should be addressed in working out the details of the proposed settlement. There is no sense paying out large sums of Government funds in excess of amounts contractually owed without obtaining proper safeguards against future unfounded claims of the type to which we have been subjected.

H. G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

28 June 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Shipbuilding claims

Ref: (a) Chapters 1-5 of a draft report entitled The Naval Ship Procurement Process Study updated 15 June 1978

(b) Assistant Secretary of the Navy (Manpower, Reserve Affairs and Logistics) Interim Report entitled Naval Ship Procurement Process Study dtd 18 Aug 1977

(c) Comments on Proposed PL 85-804 Settlement of General Dynamics Claims at Electric Boat dtd 15 June 1978

1. Reference (a) is a draft report of a study team commissioned by the Assistant Secretary of the Navy (Manpower, Reserve Affairs and Logistics) to look into the naval ship procurement process. The introduction states that the report presents the conclusions of the Naval Ship Procurement Process Study Team regarding changes to the ship acquisition process that will minimize the probability of contractor claims in the future.

2. The purpose of this memorandum is to provide my comments and recommendations concerning both the study team's draft report and the shipbuilding claims problem facing the Navy.

3. My overall impression of the study team's draft report is that it presents a narrow and unrealistic view of the problems which face the Navy in the ship acquisition process. On some issues the study team's assessment of problems is incomplete. Further, the study team failed to address some major problem areas at all.

4. Examples of issues for which the study team's draft report presents an unrealistic or incomplete picture include the following:

a. The draft report mentions the problems shipyards such as Electric Boat, Newport News and Litton experienced in expanding their work force to handle the contracts they signed. Under the terms of shipbuilding contracts, these problems are the contractor's financial responsibility. But, from reading

the draft report, one would not understand that, for the most part, the large inflated claims these companies have submitted represent efforts to attribute to the Navy full responsibility for the delays and extra costs which were caused by their work force expansions.

b. The draft report discusses the Navy's "anti-claims" clauses which were designed to obtain prompt notification and settlement of "constructive" changes. However, the study team fails to point out that shipyard officials have ignored these clauses in their claim submissions. The study team's recommendations that the Navy continue to use "anti-claims" clauses, with some changes, can only be fruitful if the Navy enforces the clauses.

c. The draft report implies that the reason shipbuilders resist pricing changes fully, in advance, is that shipbuilders have trouble pricing the effects of delay and disruption. The draft report does not discuss the real reason shipbuilders refuse to fully pre-price changes, or to price the effects of delay and disruption. Simply, the reason is that they desire to have a basis for submitting subsequent claims in the event they face cost overruns.

5. Major problems that face the Navy in the ship acquisition process which were not addressed in the study team's draft report include:

a. The tendency of some shipbuilders to let financial reporting considerations (profit or loss reports) rather than the actual merits of a contract dispute dictate the timing and size of claims. Contractors can avoid reporting losses to stockholders by reporting, as income, their own estimates of the amounts expected to be recovered against claims.

b. The changes in the business environment which have occurred since the major shipbuilding companies were acquired by conglomerate corporations. The problems faced by the Navy in administering shipbuilding contracts with these companies have included: refusals to honor contracts; the use of grossly inflated claims as a means for obtaining extra-contractual settlements; the use of claims as a device to recover cost overruns on fixed priced contracts, regardless of the contractor's own performance, or the legal merits of his claims; and threats of work stoppages.

c. The numerous instances of possible violations of federal fraud and false claim statutes which have been reported to appropriate authorities in connection with existing claims and which are now being investigated by the Department of Justice.

6. In addition to the preceding deficiencies in the study team's draft report, I find it difficult to rely on the study team's recommendations for minimizing shipbuilding claims in the future. There is no indication in either the draft report or the previous interim report, reference (b), that the study team has read any of the shipbuilding claims which have been submitted to the Navy. Nor is there any indication that the study team reviewed any of the analyses of the claims which were prepared by the Navy Claims Settlement Board.

7. In the next few weeks, Congress will be holding hearings on Navy shipbuilding claims. In the past, Navy officials, in their testimony to Congress, have tended to blame shipbuilding claims problems on prior policies and procedures and reassure Congress that corrective action for the future has been taken. Yet, we continue to face the very same problems.

8. I am concerned that the Navy, in its eagerness to show that corrective action is being taken, will proclaim that the recommendations contained in the study team's report represent a solution to the claims problem and order them adopted. I am also concerned that the proposed PL 85-804 settlements of the Electric Boat and Litton claims will be represented as putting the claims problem behind us. In my opinion, they will not.

9. While the proposed settlements may pay off the present claims to the satisfaction of the shipbuilders involved, there is not, to my knowledge, agreement regarding how future business will be conducted. For example, the Electric Boat SSN 688 Class claims made an issue of drawing revisions which are an inherent part of ship construction. While past SSN 688 Class drawing revisions are now covered by the proposed contract settlement, hundreds of drawing revisions on the TRIDENT contract which Electric Boat has accumulated are not being settled because of the company's policy of not fully pricing changes. Instead, the company insists on reserving rights to later submit claims for delay and disruption.

10. Implementation of the recommendations contained in the study team's report and the granting of extra-contractual relief as proposed for the Electric Boat and Litton claims will not solve the Navy's shipbuilding claims problem. As long as the Navy tolerates inflated claims, shipbuilders will submit them. The result will be increasing numbers of Navy technical, contractual, legal and financial personnel tied up evaluating grossly inflated claims. The Navy cannot do its job if it continues to be subjected to this sort of harassment.

11. To my knowledge no senior Navy official in recent years has taken action to indicate to shipbuilders that the Navy is unwilling to accept inflated claims. Similarly, I am not aware of senior Navy officials taking a firm stand with shipbuilders by insisting on strict compliance with contract terms and conditions, especially the "anti-claims" clauses which were designed to protect against large, after-the-fact claims. While the Navy should stand ready to pay promptly amounts it legally owes, it should be adamant in requiring contractors to honor their agreements.

12. During your visit to the Naval Reactors Facility in Idaho on 15 June 1978, I gave you reference (c) which contained my comments on the Aide Memoire reflecting the agreement between the Navy and General Dynamics on the Electric Boat claim. I summarized issues which I consider should be addressed in the proposed settlement. For the reasons discussed above, I also recommend the following:

a. Do not issue the study team's report in its present form. The study team should be required to address the problems actually faced by the Navy in administering Navy shipbuilding contracts. To increase the team's understanding of the claims problem, I specifically recommend that the team read some of the actual claims and the Navy Claims Settlement Board's detailed analyses of them.

b. Make clear to the shipbuilders and other Navy contractors that the Navy stands behind and will enforce vigorously its present regulations and contract provisions, including the "anti-claims" clauses.

c. Instruct Navy activities to reject forthwith claims which have not been certified as being current, complete and accurate or which are not properly substantiated.

d. Develop and issue standards for evaluating whether claims are properly prepared and documented.

e. Require that Navy claim analysts certify upon completion of their review of a claim item whether or not there were any indications of possible violations of federal fraud or false claim statutes. Instruct Navy personnel to report any cases of possible fraud or false claims to appropriate authorities as presently required by Navy directives.

13. I would appreciate being informed of what action you take in this matter.

H. G. Rickover
H.G. Rickover

Copy to:
Assistant Secretary of the Navy
(Manpower, Reserve Affairs and Logistics)
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Chairman, Navy Claims Settlement Board

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
28 July 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Proposed P.L. 85-804 Settlement of General Dynamics Claims at Electric Boat

Ref: (a) My 15 June 1978 Notes for Discussion with you
(b) My 28 June 1978 Memo to you
(c) General Manager, EB ltr of 28 June 78 to COMNAVSEA
(d) PMS 393 Memorandum of 19 July 1978 to COMNAVSEA (copy attached)

1. In references (a) and (b), I stated that my greatest concern about the proposed P.L. 85-804 settlement of the General Dynamics claims at Electric Boat is where this agreement leaves the Navy with respect to conducting future business. In my conversation with Secretary Hidalgo on the plane last Saturday enroute to the launching of the BREMERTON, I told him I would submit a memorandum to you this week amplifying my views. This is the memorandum.

2. As I noted in reference (a), unless special precautions are taken now, General Dynamics may well attempt, several years hence, to recover a major portion of the loss they are presently agreeing to absorb. They would do this by claiming that events subsequent to the 9 June 1978 claims release resulted in increased costs at the shipyard, and that they are eligible for a reduction in the loss because they would have otherwise finished the ships for less. The Naval Sea Systems Command was unsuccessful in negotiating the contract modification which implements the Aide Memoire so as to preclude the Company from using the inflated omnibus claims approach to recover these losses at a future date. The Company's negotiators refused to agree to the language proposed by the Naval Sea Systems Command. The contract language subsequently agreed to by Secretary Hidalgo does not take care of the problem. I predict that you or your successors will, several years from now, be faced with inflated omnibus claims on the TRIDENT and SSN 688 contracts, either to recover further cost overruns or to recoup some of the losses that General Dynamics is presently agreeing to absorb.

3. As long as shipbuilders believe that to avoid litigation or work stoppage the Navy will pay more than a claim is worth, they will continue to harass the Navy with inflated, omnibus claims. Their incentive to do so is enhanced when, as in the case of Electric Boat and Litton, the Navy settles claims on the basis of paying everything the Navy concludes it contractually owes; plus additional sums for the Navy's estimate of litigative

92-782 O - 82 - 21

risk and litigative costs; plus a 50-50 share of cost overruns resulting from matters which are the shipbuilder's contractual responsibility. In its present form, the proposed P.L. 85-804 settlement is essentially a one-time payment which leaves the Navy vulnerable in the future to unfounded and grossly inflated claims of the same sort that have plagued us in recent years.

4. Subsequent to the announcement of the P.L.85-804 settlement, Electric Boat has continued to lay the groundwork for future claims. Reference (c), for example, was submitted three weeks after agreement was reached on the proposed P.L. 85-804 settlement. In reference (c), Electric Boat officials complained to the Commander, Naval Sea Systems Command about the terms and conditions upon which the company is being asked to bid for the FY 1978/1979 SSN 688 Class procurement. Although the terms and conditions proposed by the Navy were the same as used on recent Navy procurements, Electric Boat stated the following:

> "A primary concern, which we believe would be shared by the Navy, is to have a contract document which will make it possible to deal with all aspects of equitable adjustments on a current and continuing basis, rather than have them accumulate to unmanageable proportions. In several important respects the pro-forma contract does not do that. We consider that what is needed is a total data baseline which reflects the work which is being fixed priced, including all the data which is available, at the outset of the contract, so that departures can be dealt with as they arise. The contract should be clear that departures from that baseline will be the basis for equitable adjustment, and also that where any data is being developed concurrently with the construction work, subsequent revisions to initial issues will be the basis for adjustment. Furthermore, where there are technical areas that are incapable of being reduced to a meaningful pricing baseline at the outset clear provision should be made for deferring the fixing of the price in such area. In order to implement these objectives, substantial revision is required in the article entitled "Working Drawings and Other Data" and the Changes article of the present RFP."

From a cursory reading the above appears to be reasonable but when read carefully, it can be seen that this approach would result in every drawing revision or other item of technical data submitted to the shipbuilder after contract award becoming the basis for a claim. Secretary Hidalgo and VADM Bryan, Commander, Naval Sea Systems Command, have testified at length to Congress explaining that drawing revisions are an inherent part of the ship construction process and are not contract changes as company officials frequently represent. If Electric Boat were able to get the Navy to contract on the basis proposed in reference (c), the resulting contract would be fixed priced in name only—through routine drawing revisions alone the company

would have literally thousands of items upon which to build a large, omnibus claim for whatever amount they desired. Navy and contractor personnel would once more be hopelessly tied up in claims.

5. The 19 June 1978 Memorandum of Decision and its attached Detailed Analysis, which you submitted to Congress explaining the proposed settlement, do not, in my opinion, present a fair appraisal of the design drawing issue. The Memorandum implies that the detailed design drawings should be available before ship cost can be properly estimated. The fact of the matter is that Navy ship prices are based on Navy specifications, contract drawings, and contract terms. They are not based on availability of detailed design drawings. The detailed design drawings are themselves prepared as required by the ship's specifications and contract drawings, and generally are not available at the time ships of a new class are procured.

6. In the case of the SSN 688 Class, all three bidders were furnished complete sets of the specifications and contract drawings and all had access to full scale mockups of significant portions of the ship, including the propulsion plant. On 18 April 1974, the General Manager of Electric Boat, who had been in the position for 7 years, and who had been a submarine design engineer for more than 20 years, put this matter into perspective when he told Messrs. Don L. Lynch and George H. Foster, Jr., of the staff of the Senate Armed Services Committee the following:

> "...Electric Boat Division does not have problems that the rest of the industry expresses in working with the Navy because Electric Boat Division and the Navy work hand-in-glove from conceptual design through the construction phase. This assures that we are a party to the establishment of requirements to which the ships are built.
>
> "...The cheapest way to conduct a submarine program is to build the ships in the shortest possible time. This necessitates construction starting as soon as possible. Our experience is that construction should start when less than 5% of the plans are available, with 20% available at keel laying and 80% available at launch. Over a period of years, we have worked in this fashion without excessive contract changes and it has proven to be the most cost effective program.
>
> "We have had no major problems working with Newport News' design. While certain of their details are different than we are used to, we have been able to accommodate them."

This statement was made two weeks after launch of the SSN 688 at Newport News and six months prior to the launch of the SSN 690 at Electric Boat. By that time more than 80% of the detailed design drawings had been issued.

7. As in the case of any other ship construction program, the Navy did, in fact, issue some bona fide contract changes, and some of the Government-furnished drawings were late or defective. However, through adjudication of changes and through analyses of the first and second Electric Boat claims, the Naval Sea Systems Command and the Navy Claims Settlement Board have recognized and paid for all effects of late or defective Government-furnished information which have been identified, including amounts for delay and disruption, and assessments of litigative risk. Therefore, the Decision Memorandum appears to be incorrect in creating the impression that the Navy owes Electric Boat for delay and disruption caused by late Government-furnished information beyond that included in the $97 million settlement of the first claim and the $125 million evaluation of the second claim by the Navy Claims Settlement Board.

8. In its efforts to implement the Aide Memoire, the NAVSEA proposed contract modification contained language which would have explicitly defined the basis for determining when drawing revisions constitute a change. Electric Boat, however, refused to accept this language. NAVSEA was then directed by the Secretariat to sign the contract modification without such provisions.

9. Recent actions by Electric Boat on the TRIDENT and SSN 688 programs indicate that Electric Boat intends to press the issue that every drawing revision constitutes a valid basis for future claims. For example, Electric Boat last month requested a $7,000 change to the TRIDENT contract because of a drawing revision that would require the yard to drill one hole—1½ inches in diameter by 1½ inches deep—into a steel shield box in each of seven TRIDENT submarines. The revision was approved by NAVSEA and issued to correct an Electric Boat design error before the yard started work on any of the affected shield boxes; therefore, no ripout, rework, delay, disruption, or material change was required. The entire section of the ship in which this shield box is installed was priced out by Electric Boat for the original contract on a man-hours per pound basis based on historical experience on prior ships. The actual estimate for this entire ship section was 88,500 man-hours—calculated at the rate of .096 man-hour per pound times 921,792 pounds estimated weight. Obviously, the company's bid price for the ship would not have been any different whether or not Electric Boat had prepared the original detailed drawings correctly to show the 1½ inch hole.

10. Acceptance of the Electric Boat theory concerning drawing revisions, which all shipbuilders would welcome, would make it virtually impossible for the Navy from now on to administer fixed price type shipbuilding contracts. Moreover, it has been suggested by some that follow ships should not be procured until the detailed design is complete. This would not significantly improve ship cost estimates, but would lead to increased production cost of follow ships and unnecessarily increase greatly the time required to introduce new technology to the Fleet.

11. The Detailed Analysis of the Memorandum of Decision also implies that if Electric Boat had designed the SSN 688 Class, as they did the SSN 637 Class, the design problem would have been alleviated. In regard to the relative performance of Electric Boat and Newport News as design agents, it is worth remembering that in designing the SSN 637 Class submarines Electric Boat was so late in getting some detailed design drawings to Newport News that the Navy had to give Newport News a separate design contract for portions of the ship design, so that their work on their first follow ship, the SSN 651, could proceed. Newport News delivered the SSN 651 about two months after the original contract delivery date, but three months ahead of the lead ship, being built at Electric Boat. The SSN 637 was delivered by Electric Boat 15 months after the original contract delivery date. Reference (d), a copy of which is attached, identifies other aspects of the Memorandum of Decision and its Detailed Analysis which the NAVSEA officer in charge of the SSN 688 submarine program has reported as inaccurate or misrepresented.

12. The Memorandum of Decision correctly states:

> "The second flight (11 ships) bidding posture by EB is a key to an understanding of the critical situation which later developed."

However, information which also relates to the Electric Boat overruns on the second flight is not presented in the Memorandum of Decision and its attachment.

a) At the time of negotiations for the second flight, Newport News alleged that Electric Boat was already in financial trouble on the first flight, and that Electric Boat people knew they could not build the second flight submarines at their low prices. Electric Boat, however, represented that it could build the ships for the bid amount. Because the Electric Boat offer was much lower, the Navy negotiators could not justify award to Newport News.

b) In the intervening years rumors have emanated from Electric Boat personnel that, in addition to the losses resulting from poor management at Electric Boat, a large part of the loss occurred because General Dynamics management

ordered Electric Boat management to make significant cuts in their bid estimates for both the first and second flight submarines.

c) Four years after award of the second flight contract and during Mr. Gordon MacDonald's tenure as General Manager of Electric Boat, I asked him why it had taken General Dynamics so long to recognize that there was a problem at Electric Boat. He said that, in his opinion, General Dynamics did recognize there was a problem at Electric Boat as far back as 1972, a year before the second flight contract was placed, and had sent a man to Electric Boat to investigate. Mr. MacDonald also said that in 1973, he had been sent to conduct a two-month investigation at the yard; he said he had concluded at that time that the yard was not being run adequately and that the yard needed help.

13. Despite all of the reasons that have been cited for the Electric Boat overruns, review of the costs of the first five SSN 688 Class submarines at Newport News and at Electric Boat—all 10 of which are either delivered or over 85 percent complete—shows that the expended cost for the submarines at Electric Boat is averaging about $50 million more per submarine than those at Newport News. Since the submarines at both yards are being built in the same time frame, to the same design, and essentially the same contract terms, it is not reasonable to assume that this cost difference results from late or defective design information, selection of Newport News as the ship designer, contractual terms, double digit inflation, material shortages, unwarranted optimism, differences in design between SSN 637 Class and SSN 688 Class, or strict claim analysis.

Logically, this cost difference can only result from the difference in efficiency at the two yards—which is not the Government's responsibility.

14. The manner in which the Navy justifies the proposed P.L. 85-804 settlement will have a profound impact on the Navy organization at the working level. The impression is being created that if lower levels do not find ways to justify what the contractor wants, they are not doing their jobs properly and will be subject to criticism or ridicule. This is a reversal of traditional roles. Traditionally, the burden on lower level procurement personnel has been to convince their superiors that the payment of public funds to contractors was fully justified. If the lower level personnel become convinced that the actions which will please their superiors are those which will satisfy the contractors, who will then guard the public purse?

15. In recent years, Navy officials have testified repeatedly and optimistically about steps being taken to preclude large shipbuilding claims in the future. Much emphasis has been placed on new contract clauses under which the Government absorbs a larger portion of the cost risk. In this regard I note that the Senate Armed Services Committee Report on the FY 1979 Department of Defense Appropriations sounded an appropriate note of caution concerning Navy proposed "solutions" to the claims problem. It said:

> "...Changes are being made in contracts with the purpose of preventing a recurrence of the claims problem. However, proposed contracting changes may serve only to unnecessarily transfer risk and cost from the shipbuilder to the government. Should this happen, claims may be for the most part eliminated,however, cost growth and escalation could not only remain but possibly increase—cosmetic changes are not satisfactory. Contract clauses are not an adequate substitute for prudent and proper management...."

16. With regard to the proposed P.L. 85-804 settlement, I fully share the sentiments expressed in the Detailed Analysis of the Memorandum of Decision:

> "It is paramount that Electric Boat get on with the business of building ships and that Navy officials get on with the business of administering contracts to acquire ships, free from acrimonious controversy. An inordinate amount of Navy and contractor resources has been diverted from these central tasks. The TRIDENT is certainly important to the Nation's strategic posture and the SSN 688 is an essential component of our naval forces. The Nation needs these ships. We repeat again that not granting the relief to General Dynamics defined in attachment 2 would inevitably have led to litigation lasting prolonged years with all the waste of staggering financial and human resources which this would entail. Neither side can sanely afford these consequences if, as we believe, a reasonable settlement, consonant with the national interest, has been achieved."

However, if the settlement is not truly permanent, but merely provides a short term hiatus in claims from the contractor involved, then it could become simply a precedent for the Government accepting responsibility for alleviating contractors' problems. It is one thing for the Government to show mercy to a contractor that has gotten into deep financial difficulty and has taken effective steps to mend his ways, but it is entirely another matter for the Government to bend to unsupported allegations and accept blame where it is not justified.

17. As you are aware, I advocate enforcement of Government contracts as the best means of maintaining a viable basis for conducting business over the long run. It has been my experience over a period of forty years in government procurement, that animosity and contract disputes are minimized when contractors have a clear understanding of the rules. If they know they will be held to the terms of the contracts they will bid accordingly. If they know they will be dealt with firmly when they submit unfounded, inflated or false claims, they will be much less likely to do so.

18. In my opinion, many of the problems we face today stem from the reluctance of senior Navy and defense officials in recent years to insist on contract compliance. Typically, the Navy has responded to shipbuilder criticisms of the Navy in an apologetic and conciliatory fashion even in cases where the charges were unfounded. The standard response by the Navy has been to grant more lenient terms and conditions or to offer higher settlements, as well as directing subordinates to be conciliatory, and not "rock the boat". Under these circumstances, it is not surprising that shipbuilders have responded by stepping up their attacks on the Navy—since they knew they had the support of top officials.

19. Since the facilities used to build our warships are controlled by just a few shipbuilders and since through legal maneuvering it is possible for these shipbuilders to frustrate the resolution of contract disputes for years on end, the companies have the upper hand in dealing with the Navy.

20. If we are to achieve some overall improvement in the administration of the Navy's shipbuilding program, it is not enough to simply arrive at a financial settlement which the shipbuilders will accept. We need also to settle some important issues:

a) Will the Navy stand behind its own "anti-claims" clauses and obtain shipbuilder compliance with them? If these are considered to be unenforceable, will the Navy establish new and more effective procedures?

In the early 1970's the Navy established the so-called anti-claims clauses to protect itself against large, after-the-fact claims for constructive changes—precisely the type of claims with which the Navy has been flooded in recent years. These clauses provided strict sanctions in cases where a contractor did not promptly identify an alleged constructive change or where he proceeded to perform additional work not authorized in writing by the contracting officer. In submitting their claims, Electric Boat and other shipbuilders have ignored these clauses. Moreover, Navy officials, in their efforts to settle the claims, have not enforced the clauses. Thus, unless senior Navy officials reaffirm the requirements of the existing anti-claims clauses or institute improved safeguards, and obtain

shipbuilder agreement to comply with them, the Navy will be even more vulnerable to omnibus, after-the-fact claims following this P.L. 85-804 settlement, than before.

b) Will the Navy take steps to discourage the submission of false and inflated claims by scrutinizing future claims for possible violation of federal statutes regarding fraud and false claims?

Vast Navy and contractor resources have been wasted as a result of exaggerated and unfounded claims by shipbuilders. I am not aware that Senior Navy officials have done anything to address this problem other than forward to the Justice Department specific examples reported by me and by others. In fact, for many years there has been an attitude on the part of many defense officials that unfounded and exaggerated claims are to be expected, and that they do not constitute criminal conduct. Until this attitude is discarded, and contractors know that the Navy will deal firmly with those who submit false claims, we will continue to be confronted with them.

The Deputy Attorney General has announced a Justice Department special prosecution task force on naval procurement fraud as part of his efforts to curb white collar crime. But it is incumbent on senior Navy officials to demonstrate their determination to halt the submission of false and inflated claims.

c) Will the Navy establish standards for claim submissions and reject those claims which do not meet these standards?

Admiral Manganaro, Chairman of the Navy Claims Settlement Board, has complained about the lack of documentation and support provided in shipbuilding claims. He has advocated the establishment of standards for claim submittals. I agree. Unless such standards are established and enforced, the Navy will continue to be burdened with the vast task of researching files and recreating history to document and prove conclusively that a casual allegation contained in a shipbuilding claim is incorrect.

d) Will the Navy enforce its requirement that senior responsible contractor officials certify their claims as being current, complete, and accurate?

Many shipbuilding claims have been prepared based on a selective use of facts. Often facts unfavorable to the contractor's case are not disclosed in the claims. Some shipbuilders contend it is not up to them to "make the Government's case." Although the Navy has published requirements for such certification, not all shipyards provide the certification. Moreover, to my knowledge, Navy officials have not taken management action with shipbuilders in cases where their officials have certified claims that are found upon examination not to be current, complete, or accurate.

e) Will the Navy take steps to preclude shipbuilders from being able to book income against inflated claims in reporting profits and losses to stockholders?

Often shipbuilding claims are used as the means whereby conglomerates are able to manipulate the profit and loss figures reported to their stockholders. If a contractor cannot settle a claim for the amount he desires, it is to his advantage to keep the outstanding claim on his books, regardless of its merits, because he is then able to book income against it. The more favorable profit reports that result from this practice serve to enhance the performance record of the company officials in the eyes of their superiors, their stockholders and the public.

In my opinion, the ability of companies to book income against inflated claims has been a major factor contributing to large claims and protracted contract disputes. I understand, for example, that Newport News officials have refused to accept any claim settlement that will require Tenneco to change the profit and loss figures previously reported to stockholders. In such cases, Navy claim settlement efforts are effectively limited to trying to justify paying the contractor the amount he has booked for the claim. Unless this situation is corrected, contractors confronted with potential losses will continue to have an overwhelming financial and personal incentive to submit and prosecute claims, regardless of their merits.

f) Will the Navy take steps to guarantee availability of essential shipbuilding facilities well into the future so that it will not continue to be confronted with the prospect of work stoppage or refusals to take new work on important military projects every time the Navy refuses to meet a contractor's demands?

The case has been made for the proposed P.L. 85-804 settlement that it is better to excuse a vital contractor from his contractual obligations than to be subjected to years of litigation, work stoppage, and perhaps the shipbuilder leaving the business. While the proposed settlement appears to alleviate these problems at Electric Boat for the moment, what reason is there to believe that the company will not, at some future date, again threaten the Navy in this manner?

If the Navy does not desire to buy the shipyard as part of the proposed P.L. 85-804 settlement and operate it as a Government-owned, contractor-operated plant—as I have previously recommended—then I recommend that, as a minimum, the Navy obtain a long-term, say 50 year, legally binding agreement that if the company's performance is unsatisfactory the Government will have the unilateral right to require the contractor to lease the facility to the Government or to a third party chosen by the Government at any time, so that never again

could warships be held hostage by that shipyard in a contract dispute.

21. I am well aware of the importance of solving the claim problem. I do not look forward to the prospect of years of litigation—I myself have had to waste many days of being subjected to depositions by Newport News attorneys, largely on questions that seemed to me designed more to harass obfuscate and discourage than to illuminate. If I thought the proposed P.L. 85-804 agreement would settle the problem and let the Navy get back to the real problem of building ships—which is difficult and time consuming—I would endorse it whole-heartedly. But for the reasons explained above, I believe that, at best, the problems are merely being postponed; and that without resolution of the issues I have described, the Navy is getting little, if anything, in return for the sums it proposes to pay as extra-contractual relief.

22. Often in the past, the Naval Sea Systems Command has been blamed for the fact that the claims have arisen but were not settled. This was the impression created when the last Administration attempted to settle the claims by the use of P.L. 85-804, and in subsequent testimony by senior defense officials. But even the settlement under P.L. 85-804, proposed two years ago by Deputy Secretary of Defense Clements himself, was rejected by two of the four shipbuilders. Moreover, in the present case, the disparity between the amount claimed by Electric Boat and the extent of Navy responsibility as determined by the Navy Claims Settlement Board after thorough analysis, disproves that the Navy is primarily to blame.

23. Historically, senior defense officials have explained shipbuilding problems as being the result of the actions of their predecessors, and have pointed to new studies, new policies, new procedures, as the solution for the future. By the time it becomes evident that the problems were not solved, other officials are in charge. Now, the proposed P.L. 85-804 settlement and the Navy's recently released Naval Ship Procurement Study are being heralded as providing new insights into the shipbuilding claims problems and guidance for the future. I cannot help wondering: Who will be pointed at the next time overruns resulting from contractor mismanagement occur? The Naval Sea Systems Command?

H. G. Rickover

Copy to:
Assistant Secretary of the Navy, (Manpower
Reserve Affairs, and Logistics)
General Counsel of the Navy
CNO
CNM
Chairman, Navy Claim Settlement Board
COMNAVSEA

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
14 Aug 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Problems that need to be resolved in connection with the proposed PL 85-804 settlements

Ref: (a) My 15 June 1978 Notes for Discussion with you
(b) My 28 June 1978 memo to you
(c) My 28 July 1978 memo to you
(d) My 25 March 1978 memo to the Under Secretary of the Navy

Encl: (1) Ltr from D.S. Lewis, Chairman of the Board, General Dynamics, to G.E. MacDonald and J.D. Pierce (former General Managers, Electric Boat), dtd 12 Oct 1972

1. The purpose of this memorandum is to point out the immediate need for additional actions to minimize future shipbuilding claims. In references (a), (b), and (c), I explained why I believe that the proposed PL 85-804 settlement with General Dynamics leaves the Navy vulnerable in future to unfounded and inflated claims of the same sort you are now proposing to settle. I pointed out that shipbuilders will continue to harass the Navy with unsubstantiated claims as long as they believe the Navy would rather pay off claims than face litigation or threats of work stoppage.

2. I reported that even after announcement of the PL 85-804 settlement, Electric Boat is actively laying the groundwork for future claims on TRIDENT and SSN 688 Class submarine contracts; that unless special precautions are taken now, General Dynamics may well attempt in future to recover through new claims a major portion of the $359 million loss they are presently agreeing to absorb. For these reasons, I concluded that simply paying off existing claims will not solve the problem; we need to spell out--and enforce--procedures for conducting future business.

3. Civilian Navy officials are creating an impression that the proposed PL 85-804 settlements have put the claims problem behind us; and that the settlements, together with the recommendations contained in the Navy's recently released Naval Ship Procurement Process Study, will solve the claims

problem. They will not. In fact, the problems are getting worse. Unless the Navy takes prompt action, the proposed PL 85-804 settlements will be the harbinger of a new, more costly claims era. General Dynamics is already taking advantage of the situation to establish new precedents and new methods of doing business which will guarantee the company the basis for claims well into the future.

4. The following examples, which have arisen subsequent to announcement of the proposed PL 85-804 settlement, show that in its future dealings with the Navy, General Dynamics will continue to exploit the claims process--and in a more sophisticated manner.

a. The company's recent proposal for the FY 1978/79 SSN 688 Class submarine procurement is based on a "technical baseline" defined by Electric Boat. The "technical baseline" consists primarily of specific drawing revisions and other detailed technical data on hand at Electric Boat as of certain dates. The company contends that any subsequent drawing revisions or other departures from the "technical baseline" will be changes entitling the company to an equitable adjustment. On this basis, Electric Boat's proposal is "fixed priced" in name only; the company would be able later to reprice the contract through the thousands of changes that will inevitably and unavoidably arise under such an arrangement.

b. On current contracts Electric Boat has already started to treat minor drawing revisions as claim items. However, the contracts were neither priced, negotiated, nor intended to be administered that way. For example, in pricing the TRIDENT contract, the company estimated that 88,500 manhours would be required to fabricate reactor shielding. This estimate was derived by applying the average manhours-per-pound (.096) which was expended for shielding work on a prior contract, times the estimated shielding weight (921,792) pounds. Electric Boat included the 88,500 manhours so derived in its proposed target cost. The TRIDENT contract then provides a 45 percent margin between target cost and ceiling price, to provide for uncertainties in the details of the design, errors in estimating, and other uncertainties.

Recently the detailed Government-furnished shielding drawings had to be revised to correct an error made by Electric Boat in its capacity as the Government's design agent under the TRIDENT design contracts. This revision added a requirement to drill a single 1-1/2 inch hole in a steel shield box in each of seven ships. Fabrication of the affected part had not yet begun, so no ripout, rework or disruption was involved.

Nonetheless, the company contends that the drawing revision constitutes a change to the contract and has quoted a price of $1,000 per ship to drill the hole. The Navy has rejected this request. Soon, I expect we will get a letter announcing that the company is proceeding with the work subject to submitting a claim.

c. Although the company, in connection with the PL 85-804 settlement, has agreed to price changes fully and promptly, it is now inflating the price of changes by adding a 50 percent factor for "acceleration of unchanged contract work" and a 25 percent factor for labor "ineffectiveness." Specifically, the company is now alleging that performance of work on changes requires an acceleration of unchanged work to minimize the "delaying effect" of the change. In order to recover from the effects of the change, Electric Boat claims it will be forced to extend its workdays and expend an amount of overtime manhours equivalent to the manhours added by the change.

In addition, EB states that overtime will decrease productivity, and that the resultant loss of labor effectiveness will constitute 25 percent of each overtime hour worked. The company has now begun to quote changes for the TRIDENT and SSN 688 Class contracts on this basis.

The Navy does owe its contractors the legitimate costs of contract changes, including any associated delay, disruption, or acceleration costs. But the price of changes should not be padded by inclusion of arbitrary and unsubstantiated factors.

d. In addition to inflating the price of contract changes, the company insists that fully priced contract modifications will be contingent upon implementation of the PL 85-804 settlement. That way, if the settlement is not implemented, the modification would be transformed into a unilateral unpriced change order, and subject to a claim. Since Congressional action on the proposed settlement obviously does not affect the actual impact a change will have on ship construction, schedules, and costs, the company is demonstrating once again it is willing to settle issues on their contractual merits, only so long as its demands on other fronts are first met.

e. Electric Boat continues to dispute, before the Armed Services Board of Contract Appeals, the so-called Electric Boat Overhead Ceiling Agreement. As partial consideration for receiving the TRIDENT design contract, the company agreed to absorb all overhead costs in excess of a predetermined ceiling. This ceiling was subject to adjustment to accommodate changes

in workload. Under this agreement the company now owes the Government in the neighborhood of $30 million. Rather than pay that amount, however, the company reneged on the agreement, and the dispute must now be litigated.

As in the case of the Electric Boat Overhead Agreement, the proposed PL 85-804 settlement calls for General Dynamics to absorb certain contract costs that would otherwise be allowable. What reason then is there to believe the company will honor its contractual commitment to absorb the $359 million loss described in the proposed PL 85-804 settlement?

5. Given where we are today, the first priority for the Navy should be to obtain from General Dynamics officials a legally binding commitment to handle contract changes solely on their merits, and in accordance with the practices followed for many years previously. This will require the company to abandon forthwith the notion that the Navy will award or administer contracts on the basis that revisions to drawings or other technical data automatically become contract changes.

6. In drafting the contract modification to implement the proposed PL 85-804 settlement, the Naval Sea Systems Command tried to put to rest once and for all, the much-publicized controversy over drawing revisions. This was to be accomplished by reiterating in the contract what has been the practice for many years. The Command included the following provision in the contract modification:

> "The parties agree that revisions to Government-furnished working drawings and other data are an inherent feature of ship construction contracts and that revisions to such drawings or design data, provided they are furnished in a timely manner to support construction, do not entitle the Contractor to an equitable adjustment except to the extent that such revisions: (i) result in changes to the requirements of the 'Specifications for Building Submarines SSN 688 Class' or conflict with contract guidance drawings or (ii) require rip out or rework, or changes to contractor-furnished material already on order; provided, that no such equitable adjustment shall be made with respect to any revisions to drawings or design data unless the Contractor has complied with all requirements of paragraphs (b) through (h) of the 'Changes' Clause."

Electric Boat returned the proposed contract modification with the above words deleted. Shortly thereafter Assistant Secretary Hidalgo took over the negotiations and agreed to a contract modification which ignored the drawing revision issue. The Commander, Naval Sea Systems Command, pointed out the need to resolve this issue. Resolution of the drawing revision issue is doubly important because it has been widely distorted

and misunderstood in Congress and in the press.

7. Recently, the Naval Sea Systems Command received a copy of a 28 July 1978 letter from Secretary Hidalgo to Mr. Veliotis, General Manager of Electric Boat. The letter apparently was an attempt to address this concern, but it missed the point entirely. The letter states:

> "With a view to underscoring the firm and enduring character (underlining added) of our settlement agreement, I wish merely to add one thought which I believe is implicit in your letter. The finality which we seek by fully pricing changes under the TRIDENT and SSN 688 contracts, without reservation of rights with respect to delay and disruption, would apply equally to those drawing revisions, essential to ship construction, which you accept on a 'no cost' basis."

8. Secretary Hidalgo's letter in actuality weakens the Naval Sea Systems Command position. The letter can be construed as implying that all drawing revisions are contract changes--exactly the precedent Electric Boat is trying to establish. Secretary Hidalgo's letter asks only that in cases where Electric Boat accepts a drawing revision on a no-cost basis, the company will not later file a claim for delay and disruption. Nothing in Mr. Hidalgo's letter requires Electric Boat to acknowledge that nearly all routine drawing revisions are not changes nor does his letter spell out criteria for determining when drawing revisions are contract changes. This was the objective of the contract provision proposed by NAVSEA. For these reasons Mr. Hidalgo's letter is totally ineffective in preventing Electric Boat from treating every drawing revision as a contract change, and, therefore, subject to a claim.

9. To avoid another large backlog of unsettled claims following on the heels of the PL 85-804 settlements, I recommend that the Navy obtain General Dynamics agreement to the substance of the language concerning drawing revisions quoted in paragraph 6 above. I further recommend you request Mr. Lewis, the Chairman of the Board of General Dynamics, to reiterate to the present management of Electric Boat the corporate policy statement he previously expressed in enclosure (1). Enclosure (1), which was transmitted to Electric Boat employees, instructs them to handle Navy funds as they would corporate funds; to ensure that all charges assigned to a contract are reasonable and proper; and to cooperate fully with the spirit and the letter of agreements regarding Government access to company books and records. With respect to the administration of Navy shipbuilding contracts, enclosure (1) states:

"All financial, contractual and technical matters must be handled on a straightforward basis with the Government. ....It is the responsibility of the Corporation and Electric Boat Division to establish the propriety of practices questioned by Navy or Government representatives without resorting to technicalities or loopholes. If we cannot demonstrate that our practices are clear, fully legal and proper, we must change them to the satisfaction of the Government."

Recent experience indicates that reiteration of these principles at Electric Boat and at other shipyards is warranted.

10. In addition to the foregoing, the Navy should make it clear to General Dynamics that it will not contract for future ships on the approach for defining the "technical baseline" proposed by the company. Otherwise, the advantages and discipline of competitive bidding and fixed priced contracting would be lost. A shipbuilder could then bid low with the expectation of later repricing the contract through the thousands of minor drawing revisions which would then become contract changes under the Electric Boat approach.

11. No doubt General Dynamics officials attach great importance to winning the FY 1978/79 SSN 688 Class submarine contract. What better way to restore stockholder and public confidence than by winning, at this critical time, a major contract from the Navy in competition with Newport News? To the public it would signify that the problems at Electric Boat are over, the company has been rehabilitated, and now has the blessing of the Navy. The problems at Electric Boat are not over. As I have said repeatedly, it would be a serious mistake to award additional ship contracts to Electric Boat until the company demonstrates, by actual performance, that it has control over its work force and can perform work efficiently.

12. I have reflected on the claims problems the Navy has experienced with Electric Boat and with other shipbuilders during the 1970's. Several points stand out:

a. The major shipbuilders and their attorneys have proved they can generate interminable delay in contract disputes to the point that issues are not settled on their merits.

b. Whereas there is permanence among those in the shipyards who work on claims and contract disputes, the Navy suffers from a rapid turnover of personnel and is always at a disadvantage. There is also a huge disparity between the Navy and the shipbuilder in the manpower they are able to apply to contract disputes.

c. The more militant a contractor is in dealing with the Navy, the better he makes out. By trying to be conciliatory, without understanding the background or the facts--or without consulting with their subordinates who have this information--senior Navy officials often make the business relations worse.

d. By trying to avoid litigation, even in cases where the parties are apart on important issues of principle, the Navy rarely follows its own stated procedures for settling contract disputes. Some of the cases before the Armed Services Board of Contract Appeals have been interrupted repeatedly to give subsequent negotiating teams an opportunity to reach a settlement. The result has been a period of years in which there has been no visible progress in settling basic issues. During this period, Congressional and public sympathy was aroused for the shipbuilders who were not able to get their claims resolved. All of this has made the Navy look stupid, and not capable of doing its job. The histories of the CGN 41 case with Newport News and the Litton LHA claim illustrate the problem to which I refer.

e. Civilian Navy officials not familiar with the intricacies of shipbuilding contracts, but who wanted to show that the Navy was "reasonable," have accepted for the Navy far more blame than the facts warranted. Moreover, over the years they have been too willing to attribute the problems to contract clauses and procurement procedures--and have proposed solutions in this light--rather than address the problems of false and inflated claims and expose the financial manipulations behind them. This is the fundamental flaw in the Navy's recently released Naval Ship Procurement Process Study.

13. To conduct business on a pay-as-you-go basis and to protect adequately against large after-the-fact claims, the Navy Secretariat needs to reaffirm its support for our so-called "anti-claims" clauses and strictly enforce them--or devise a better method. Reference (d) explains in detail the basis of the anti-claims changes clause; the extent to which the Office of Navy General Counsel is rendering the clause inoperative through interpretation; and my inability to get the Navy General Counsel to address the issues I have raised. Since the Office of Navy General Counsel had been unresponsive I requested, in reference (d), assistance from the Under Secretary. Four months later, reference (d) still remains unanswered.

14. To me it appears senseless for the Navy to develop contract clauses and procedures to protect the Government against large, after-the-fact claims based on alleged constructive changes, and then make no effort to enforce these safeguards. Similarly,

it is beyond my comprehension why some Navy attorneys are now so eager to conclude, without benefit of an actual court test, that the requirements and sanctions of the anti-claims changes clause cannot be enforced.

15. In my opinion, the Navy's present Changes clause, if enforced, would be an effective deterrent against large, after-the-fact claims. I have regretfully come to the conclusion that the reluctance of the Office of Navy General Counsel to enforce the clause stems more from efforts to help justify Navy settlement proposals than from any inherent legal deficiency in the clause. In any event, if the Secretariat truly believes the requirements and sanctions of the Navy's anti-claims changes clause to be unenforceable, the clause should be immediately revised to achieve the basic objectives originally sought.

16. The Navy Secretariat needs to make it completely clear to shipbuilders that false and inflated claims will hereafter not be tolerated, and that the Navy will make every effort to see that violators are prosecuted. The practice of submitting grossly inflated claims is now well established. Although false and inflated claims waste thousands of hours of effort by Navy people involved in shipbuilding, senior civilian Navy officials have tended to ignore or play down the problem. To my knowledge, the Navy Secretariat has never evidenced any outrage over the practice, nor taken steps to stop it.

In this regard, I recommend that you take the following action and notify the shipbuilders accordingly:

a. Establish standards for claims submissions, and instruct contracting officers to forthwith reject claims which do not meet these standards.

b. Require that every claim item for which the Government concludes there is no entitlement be scrutinized for possible violation of federal fraud or false claims statutes.

c. Require Navy claims analysts to certify that any evidence of possible fraud or false claims has been identified and reported as required by existing Navy directives.

d. Forward promptly to the Justice Department any suspected violations of federal fraud or false claims statutes, urge prosecution, and cooperate fully with that Department in any ensuing investigation or prosecution.

e. Insist, without exception, that all shipbuilders comply with the Navy's requirement for certification of claims and supporting data at the time of claim submission.

17. The Navy must discourage contractors from generating claims and contract disputes simply as a means to conceal large losses in their financial reports to stockholders. This has been a persistent problem. For example:

a. By booking income against shipbuilding claims, General Dynamics was able to report to stockholders record high after-tax earnings of $103 million for 1977. But, in fact, the company was facing an $843 million potential loss on its SSN 688 contracts alone.

b. By booking income against the LHA and DD 963 claims, Litton has been able to report profits to its stockholders for many years, without including the potential $647 million loss on these two contracts.

c. By booking income against claims, Newport News has been able to report record profits year after year even though the company has complained about potential losses on its Navy shipbuilding contracts and is currently experiencing large losses on its commercial work. I understand that the company's position is that, regardless of the value the Navy assigns to their claims, any claim settlement must cover the amount of income anticipated from claims which Newport News has already booked for profit reporting purposes.

18. The ability to book income against inflated claims is a major impediment to the prompt resolution, on their legal merits, of claims and contract disputes. As long as the Government permits contractors to book income against inflated claims, contractors facing a potential loss will have a strong financial incentive to precipitate and perpetuate contract disputes for financial reporting purposes. I recommend, therefore, that the Navy work with the Securities and Exchange Commission to establish standards which would permit the booking of income against unadjudicated claims or change orders only to the extent they have been authorized in writing by the contracting officer and at a ceiling price.

If the Government agrees that a contractor is due extra sums in a certain amount he should be permitted to take credit for that in his accounting. However, he should not be permitted to book income predicated on the favorable outcome of litigation or payments on claims based on alleged "constructive changes."

The possible implications of favorable settlements could be explained in the company's annual report, but the profit and loss figures published in the financial statements should not presume favorable settlements. Such standards would provide contractors a stronger incentive to submit only valid claims and prosecute them to a swift resolution.

19. The Navy needs effective methods of dealing with a company which, to further its financial interests, refuses to honor its contracts and threatens work stoppage and lengthy litigation on important military contracts. A contract is supposed to reflect a meeting of minds. But it becomes waste-paper if one of the parties, rather than live up to the spirit of the agreement, tries to twist it into something unenforceable. Contractors, clever attorneys, and claims specialists can always devise new theories and strategies to create a dispute which can then lead to more threats of work stoppage and litigation. Since the Navy is proposing to settle both the Litton and Electric Boat claims for substantially more than their merits in order to avoid litigation, it is only reasonable to expect more threats of litigation and work stoppage in the future.

20. I have previously recommended that if a shipbuilder refuses to honor his contracts and the Navy must resort to extra-contractual relief under Public Law 85-804 to avoid work stoppage, lengthy litigation, or boycotting of future Navy business, the Navy should at the same time take steps to ensure that no longer will Navy warships be held hostage to the financial demands of that contractor. In addition, if the Navy must end up paying a shipbuilder's costs, regardless of contractual responsibility--because he controls access to production facilities needed for defense work--steps should be taken <u>now</u> to establish viable alternatives.

21. One alternative would be for the Navy to buy the shipyard as part of an overall claim settlement and have a contractor operate it on a cost reimbursement basis as a Government-owned, contractor-operated (GOCO) shipyard. Alternatively, the Navy could leave the shipyard under private ownership but obtain the unilateral right to cause the company to lease the shipyard to any third party of the Government's choosing. A third possibility is to reestablish a new construction capability in Naval Shipyards. Under any of these alternatives, we would have protection against companies who provide unsatisfactory management, refuse to honor contracts, or attempt to deny facilities essential for Navy shipbuilding work.

22. I fully understand that not all of the alternatives I have suggested can be implemented immediately, and that under existing circumstances you are committed to the proposed PL 85-804 settlement. I recognize that this settlement was not intended to be a comprehensive solution of all shipbuilding problems. However, I believe there are immediate steps you can and should take prior to implementing the PL 85-804 settlement to help preclude Electric Boat from flooding the Navy with claims in the future, as well as to establish a proper base for future business.

23. Therefore, I recommend that before the proposed PL 85-804 settlement takes effect, you:

a. Obtain General Dynamics' agreement to the substance of the language concerning drawing revisions quoted in paragraph 6 above.

b. Obtain General Dynamics' written commitment to price changed work only on the basis of costs that can be substantiated. The company should be compensated for delay, disruption, acceleration, and so forth, when these are the verifiable result of Navy directed changes. However, no pricing policies should be permitted which absolve Electric Boat of its responsibility to accommodate a normal amount of changed work within the anticipated period of contract performance.

c. Obtain the agreement of the Chairman of the Board of General Dynamics to reissue enclosure (1) reaffirming corporate policy that: "All financial, contractual and technical matters must be handled on a straightforward basis with the Government."

d. Make it clear to General Dynamics that the Navy will not contract for ships on the basis of the approach for defining the "technical baseline" proposed by the company.

24. The actions cited above will not solve the claims problem. Past experience has shown that shipbuilders are unlikely to honor their commitments as long as they know the Navy is unable or unwilling to enforce its rights. Therefore, to establish the Navy's credibility with respect to enforcing its contracts and protecting the public against unsubstantiated claims, I also recommend that you:

a. Make it clear that the Navy affirms its anti-claims clauses and will strictly enforce them in future.

b. Establish standards for claims submissions and instruct contracting officers to reject claims which do not meet these standards.

c. Require that any claim item for which the Government concludes there is no entitlement be scrutinized for possible violation of federal fraud or false claims statutes.

d. Require Navy claims analysts to certify that any evidence of possible fraud or false claims has been identified and reported as required by Navy directives.

e. Forward promptly to the Justice Department any suspected violations of federal fraud or false claims statutes, cooperate fully with the Department in any ensuing investigation or prosecution, and urge that Department to prosecute quickly.

f. Insist that all shipbuilders comply with the Navy's requirement for certification of claims and supporting data at time of submissions.

g. Work with the Securities and Exchange Commission to establish standards for booking income against unsettled claims.

h. Devise a permanent arrangement which will protect the Navy from future work stoppages or threats of work stoppage. In this connection you should consider the three alternatives cited in paragraph 21 above.

25. As I have stated to you and to others, I do not object to the decision to settle the outstanding claims under PL 85-804. You have identified the amount of the settlement that is over and above what you consider the Navy owes under the contracts; by law the authority to grant extra-contractual settlements is vested in you, subject to Congressional review.

26. I strongly recommend, however, that before the settlements take effect the outstanding issues with respect to the conduct of future business be fully resolved as I have described above. Unless you do this, we will end up with the worst of two worlds--all the problems of bidding, negotiating, and administering fixed priced contracts, but because of price reopeners and claims, none of the financial discipline that is required to make fixed priced type contracts superior to cost type contracts.

27. An influx of new claims and contract disputes on the heels of a PL 85-804 settlement, or shortly thereafter, would further damage the Navy's already sagging credibility. As you are aware,

this lack of faith by Congress and our people has resulted in a lowered shipbuilding program. It is essential that the actions we take today solve the problems, not exacerbate them.

28. I look forward to discussing these matters with you later this week.

H. G. Rickover

Copy to:
Under Secretary of the Navy
Assistant Secretary of the Navy
(Manpower, Reserve Affairs and Logistics)
General Counsel of the Navy
Chief of Naval Operations
Chief of Naval Material
Chairman, Navy Claims Settlement Board
Commander, Naval Sea Systems Command

COPY

12 October 1972

To: G.E. MacDonald, J.D. Pierce

CC: M. Golden, E.E. Lynn, T.L. McPherson, J.W. Rannenberg, W. Wells

From: D.S. Lewis

Subject: Necessary Improvement of Electric Boat's Financial and Operating Procedures

IT IS VERY IMPORTANT THAT THE FOLLOWING CORPORATE POLICY STATEMENT BE TRANSMITTED TO GENERAL DYNAMICS CORPORATE OFFICE AND ELECTRIC BOAT DIVISION PERSONNEL CONCERNED IN THE FINANCIAL AND OPERATIONAL ADMINISTRATION OF NAVY CONTRACTS.

1. In recent weeks questions have been raised concerning certain practices at Electric Boat, particularly with regard to proper cost charging and the proper administration of our submarine contracts with the Navy.

2. I want you to avoid any impropriety whatsoever, and any action which could appear to be improper, in our dealings with the Navy. Therefore, it is most important that everyone understand exactly what our company's policies are in this important area:

(a) It is to the best long term interests of the United States Government and General Dynamics that the administration of all of our contracts be on a completely open and above board basis. All financial, contractual and technical matters must be handled on a straightforward basis with the Government. It is our responsibility to develop and follow practices and procedures which can be well understood by Electric Boat and the Government to insure that no impropriety can arise. The very fact that nearly 100% of Electric Boat's business is with the Navy should make it quite easy to develop straightforward operating procedures. It is the responsibility of the Corporation and Electric Boat Division to establish the propriety of practices questioned by Navy or Government representatives without resorting to technicalities or loopholes. If we cannot demonstrate that our practices are clear, fully legal and proper, we must change them to the satisfaction of the Government.

(b) We must be careful to insure that all charges assigned to a contract are reasonable and proper. Where the appropriateness of a charge or a method of accounting is in doubt, we must take the initiative to bring the item in question to the attention of the Government for early resolution.

(c) Our people must take positive action to insure that proper practices are followed by all of our suppliers and subcontractors. Our dealings with our subcontractors must be completely open, completely at arm's length and completely businesslike.

(d) As a result of recent discussions, we have agreed to give the Government access to certain of our financial books, records, and other data when such access is desired to determine the appropriateness of costs charged to Navy contracts. Electric Boat and Corporate Office personnel should cooperate fully with the spirit and the letter of these agreements to be sure the Navy receives the information on a timely basis.

3. I am firmly convinced that an open and candid relationship between the Electric Boat and Navy people will, in the long run, work equally to the financial well-being of our people, our company and our customer. We can expect Electric Boat's sales and earnings to remain healthy only if we meet our obligation to see that all funds are well managed and that the Navy gets full value for each dollar spent. Navy funds must be handled as we would handle corporate funds, or for that matter, our own personal funds.

4. It is mandatory that early action be taken to review all of the Electric Boat practices and procedures to insure that they meet the criteria outlined above; where they do not, early corrective action must be taken. To expedite this entire activity, Gordon E. MacDonald, Executive Vice President-Finance, is directed to spend at least 50% of his time at Electric Boat working on this project, effective immediately. He has full authority to make any decisions concerning changes in our practices and procedures and has full authority to settle any items requiring negotiation with the Navy. I want to be kept advised of progress on an oral basis at least weekly and Mr. MacDonald and Mr. Pierce are directed to send to me, no less frequently than once a month, a written report outlining the progress made to date and including a definitive list of problem areas uncovered and corrective actions taken.

/signed/ David S. Lewis
Chairman

DIVISION NOTICE

NO. 203

November 14, 1972

Subject: Necessary Improvement of Electric Boat's Financial and Operating Procedures

This supersedes Division Notice No. 201.

IT IS VERY IMPORTANT THAT THE FOLLOWING CORPORATE POLICY STATEMENT BE TRANSMITTED TO GENERAL DYNAMICS CORPORATE OFFICE AND ELECTRIC BOAT DIVISION PERSONNEL CONCERNED IN THE FINANCIAL AND OPERATIONAL ADMINISTRATION OF NAVY CONTRACTS.

1. In recent weeks questions have been raised concerning certain practices at Electric Boat, particularly with regard to proper cost charging and the proper administration of our submarine contracts with the Navy.

2. I want you to avoid any impropriety whatsoever, and any action which could appear to be improper, in our dealings with the Navy. Therefore, it is most important that every one understand exactly what our company's policies are in this important area:

   (a) It is to the best long term interests of the United States Government and General Dynamics that the administration of all of our contracts be on a completely open and above board basis. All financial, contractual and technical matters must be handled on a straightforward basis with the Government. It is our responsibility to develop and follow practices and procedures which can be well understood by Electric Boat and the Government to insure that no impropriety can arise. The very fact that nearly 100% of Electric Boat's business is with the Navy should make it quite easy to develop straightforward operating procedures. It is the responsibility of the Corporation and Electric Boat Division to establish the propriety of practices questioned by Navy or Government representatives without resorting to technicalities or loopholes. If we cannot demonstrate that our practices are clear, fully legal and proper, we must change them to the satisfaction of the Government.

(b) We must be careful to insure that all charges assigned to a contract are reasonable and proper. Where the appropriateness of a charge or a method of accounting is in doubt, we must take the initiative to bring the item in question to the attention of the Government for early resolution.

(c) Our people must take positive action to insure that proper practices are followed by all of our suppliers and subcontractors. Our dealings with our subcontractors must be completely open, completely at arm's length and completely businesslike.

(d) As a result of recent discussions, we have agreed to give the Government access to certain of our financial books, records, and other data when such access is desired to determine the appropriateness of costs charged to Navy contracts. Electric Boat and Corporate Office personnel should cooperate fully with the spirit and the letter of these agreements to be sure the Navy receives the information on a timely basis.

3. I am firmly convinced that an open and candid relationship between the Electric Boat and Navy people will, in the long run, work equally to the financial well-being of our people, our company and our customer. We can expect Electric Boat's sales and earnings to remain healthy only if we meet our obligation to see that all funds are well managed and that the Navy gets full value for each dollar spent. Navy funds must be handled as we would handle corporate funds, or for that matter, our own personal funds.

4. It is mandatory that early action be taken to review all of the Electric Boat practices and procedures to insure that they meet the criteria outlined above; where they do not, early corrective action must be taken.

J. D. Pierce
General Manager

Distribution

Management Manual Holders

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
24 Aug 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Shipbuilding claims

Encl: (1) NAVSEA ltr Ser 08I-383 dtd 23 Aug 1978, subj: S6G Project - Proposed Modification of Monitor Tube & Installation of Steam Shroud on Reactor Vessel Test Head in the SSN 698 (Contract N00024-71-C-0268) - Disapproval of
(2) Electric Boat ltr from J.D. Pierce to ADM Rickover, dtd April 20, 1974, subj: Significant points raised during visit of Messrs. Lynch & Foster to Electric Boat on 18 April, 1974

1. During our meeting last Friday I left with you several documents which show that, notwithstanding the proposed PL 85-804 settlement, General Dynamics is already laying the basis for future claims on Navy shipbuilding contracts at Electric Boat. Since you expressed interest in seeing specific examples, together with supporting documentation, I am sending you enclosures (1) and (2).

2. Enclosure (1) is my formal response to one of the Electric Boat contract change proposals I left with you last Friday. The change proposal addresses problems discovered with a Government-furnished reactor vessel test head during testing of SSN 698. Although the work included in the contract change proposed by Electric Boat was technically desirable, I decided not to authorize it for two reasons: First, the price of the proposed change included arbitrary and unsubstantiated factors. Second, according to the terms being proposed by Electric Boat, the company would recant all prior agreements on the price and delivery impact of the change, if the PL 85-804 settlement is not implemented.

3. Enclosure (1) notified the Supervisor of Shipbuilding that NAVSEA will not authorize the contract change on the terms requested by Electric Boat. It also requests the Supervisor to bring this issue to the attention of the General Manager, Electric Boat and:

a. Advise the General Manager that quotations such as this and several other recent EB quotations are unacceptable to the Navy and prevent the Navy from having desirable work accomplished.

b. Request the General Manager to take action to provide fully priced and substantiated proposals in the future, and

c. Request the General Manager to advise the Supervisor of his intentions in this regard.

4. Enclosure (2) is another document germane to the drawing revision issue we discussed last week. According to enclosure (2), on April 18, 1974, the then General Manager of Electric Boat told staff members of the Senate Armed Services Committee:

"j. Electric Boat Division does not have problems that the rest of the industry expresses in working with the Navy because Electric Boat Division and the Navy work hand-in-glove from conceptual design through the construction phase. This assures that we are a party to the establishment of requirements to which the ships are built."

* * * *

"l. The cheapest way to conduct a submarine program is to build the ships in the shortest possible time. This necessitates construction starting as soon as possible. Our experience is that construction should start when less than 5% of the plans are available, with 20% available at keel laying and 80% available at launch. Over a period of years, we have worked in this fashion without excessive contract changes and it has proven to be the most cost effective program."

* * * *

"m. We have had no major problems working with Newport News' design. While certain of their details are different than we are used to, we have been able to accommodate them."

Although I previously referred to enclosure (2) in my 28 July 1978 memorandum to you, I wanted you to have the actual document.

5. The specific examples cited during our meeting, together with the enclosures to this letter, show that General Dynamics is embarked again on the "claims route"--even before the PL 85-804 settlement is consummated. The company is apparently trying to establish a new method of conducting business--one which will lead to many claims and contract disputes.

6. In this regard, I just received a copy of the Navy's response to questions asked by Senator Proxmire. Considering what is currently going on at Electric Boat with respect to claims, the Navy's answers to questions 24 and 28 could prove to be embarrassing--particularly the following statements:

In regard to drawing revisions:

"EB has agreed to abide by the so-called anticlaims clauses. The notification and negotiation procedures in these clauses have been modified to allow for an orderly administration process to identify and price out changes as they occur. EB has also agreed to fully price out changes on both the 688 and TRIDENT contracts. Both of these actions, which are part of the approved contract modification, should alleviate the potential for claims." (emphasis added)

In regard to Electric Boat's future intentions:

"It is difficult to comprehend why EB would consider claims as a means to recover losses. Rather it is the view of the Navy that EB will focus attention on building SSN 688 and TRIDENT submarines in an efficient manner."

7. I am concerned that by proceeding with the PL 85-804 settlement and making euphoric statements about the future, in the face of Electric Boat's clear expression of intent to continue on the claims route, the Navy may be constructively ratifying the contractor's new practices. Further, unless these practices are stopped now, the Navy will find itself devoting increasingly large amounts of technical and other personnel resources to contractual issues and litigation--and not accomplishing the purpose of the PL 85-804 settlement.

8. As you stated during our meeting, no contract language nor statute can be worded so tightly that companies and their attorneys cannot, in the absence of a proper business relationship, generate a legal dispute. We need to restore some semblance of the traditional customer relationship in our shipbuilding business.

9. In view of the current claims attitude by Electric Boat I reiterate my recommendation that, in granting extra-contractual relief, you obtain from the senior corporate officials involved a written policy statement in which he sets forth the principles under which future business is to be conducted with the Navy; that this policy statement should be distributed throughout the company and address in a manner satisfactory to the Navy three major issues: drawing revisions, enforcement of the so-called anti-claims clauses, and false and inflated claims.

10. I also recommend adoption of the other recommendations contained in my August 14, 1978 memorandum to you.

H. G. Rickover

Copy to:
Under Secretary of the Navy
Assistant Secretary of the Navy
(Manpower, Reserve Affairs and Logistics)
General Counsel of the Navy
Chief of Naval Operations
Chief of Naval Material
Chairman, Navy Claims Settlement Board
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
Ser 08I-383
23 August 1978

From: Commander, Naval Sea Systems Command
To: Supervisor of Shipbuilding, Conversion and Repair, USN, Groton, CT

Subj: S6G Project - Proposed Modification of Monitor Tube and Installation of Steam Shroud on Reactor Vessel Test Head in the SSN 698 (Contract N00024-71-C-0268) - Disapproval of

Ref: (a) KRMO-GTN TWX S6G-77710-MAO dated 11 July 1978
(b) MAO TWX A-0026 dated 14 July 1978
(c) SUPSHIP letter 410B-7110 dated 27 July 1978
(d) Electic Boat Contract Change Proposal R-34631 dated 10 August 1978

1. Background: During initial primary system testing, a hydrostatic test head is installed on the reactor vessel. The test head has an inner and an outer O-ring to form a seal between the test head and reactor vessel. Normally, the inner O-ring adequately seals the primary pressure. Any leakage flows out a monitor tube furnished by the shipyard and installed between the O-rings.

2. During primary system testing beginning the week of July 10, 1978, the test head in the SSN 698 leaked 5 gallons per minute (gpm) past the inner O-ring at a loop pressure of 1250 psig. Reference (a) forwarded an Electric Boat (EB) recommendation that because of the excessive leakage, the test head be replaced with the one successfully used in the SSN 697. EB also noted that there was a slight amount of leakage past the outer O-ring and considered that this could be hazardous to personnel as the plant pressure and temperature increased.

3. In reference (b), MAO did not concur with the EB recommendation. MAO noted that the inner O-ring had not been subject to sufficient pressure differential to seat it. To increase the differential pressure across the inner O-ring, MAO concurred with the KRMO recommendation that the shipyard replace the present 1/4 inch monitor tube piping and valves with 1/2 inch piping and valves. MAO calculated that the larger monitor tube would result in a differential pressure across the inner O-ring of 2270 psid in lieu of 1050 psid at a loop pressure of 2750 psig and should cause the inner O-ring to seat. This work was completed on 17 July 1978.

4. If the leakage past the inner O-ring is still excessive, then the monitor tube isolation valve can be closed and the outer O-ring pressurized. Because of this possibility, MAO recommended that a steam shroud be installed around the test head as was done in previous submarines to contain any leakage past the outer O-ring.

92-782 O - 82 - 23

5. In reference (c), SUPSHIP Groton requested that EB provide an estimate of the cost to replace the monitor tube piping and install the steam shroud.

6. EB Proposal: In reference (d), EB proposed a target price of $8,592 to replace the present monitor tube piping and valves with larger piping and valves and to install the steam shroud. However, the pricing in the reference (d) proposal is based on "acceleration" of unchanged work to minimize the "delaying effect" of the change. In order to recover from the "delaying effect", EB claims it will be forced to extend its workdays and expend overtime equivalent to the manhours added by the change.

Reference (d) further states that overtime will decrease productivity, and that the resultant "loss of labor effectiveness" will constitute 25 percent of each overtime hour worked. This "loss of labor effectiveness" factor is also priced into the EB proposal.

In addition, reference (d) contains the following contractual statement:

"This adjudication is on a fully priced and final basis predicated on Modifications P00024 (Contract N00024-71-C-0268) and P00014 (Contract N00024-74-C-0206) becoming effective. If the aforementioned modifications do not become effective this FMR shall be deemed to be a unilateral unpriced change order effective as of the date of execution of this SF-30."

7. NAVSEA Discussion:

a. Previous experience has shown that the leakage past the O-rings has decreased as the plant temperature and pressure were increased. If the leakage rate past the inner O-ring does not decrease sufficiently and the monitor tube is closed so that the outer O-ring is pressurized, the leakage past the outer O-ring will be small based on past experience. Therefore, while the steam shroud may be desirable, it is not technically required.

b. Although the work of the proposed change is technically desirable, NAVSEA will not authorize this work on the terms of the reference (d) proposal discussed above. NAVSEA considers that its contractors are owed the legitimate costs of contract changes, including any associated delay, disruption, or acceleration costs. However, the price of changes should not be increased by inclusion of arbitrary and unsubstantiated factors.

c. In addition, NAVSEA does not accept the contractual condition included in reference (d) as cited in paragraph 6. of this letter. This condition would transform a fully priced contract modification into a unilateral unpriced change order, subject to a claim, if the proposed PL 85-804 settlement is not implemented. NAVSEA considers that Congressional action on the proposed settlement does not affect the actual impact a change will have on ship construction, schedules, or costs. Further, the effect, if any, on the fair price for the change is insignificant and EB is able, if it wishes, to estimate it. It surely does not require or warrant subsequent conversion of a fully priced contract modification to a unilateral, unpriced change.

Ser 081-383

8. NAVSEA Action: Based on the discussion in paragraph 7 above, NAVSEA does not authorize the proposed contract change.

9. It is requested that you bring this letter to the personal attention of the General Manager, EB Division and: 1) Advise him that quotations such as this and several other recent EB quotations are unacceptable to the Navy and prevent the Navy from having desirable work accomplished, 2) Request he take action to provide fully priced and substantiated proposals in the future, and 3) Request he advise you of his intentions in this regard.

10. The action taken by this letter is considered by NAVSEA to be within the scope of existing contracts and except for the cost of preparing the proposal requested by reference (c), no change in contract delivery or completion dates or in the current negotiated price or amount of any Government contract is authorized.

H. G. RICKOVER
Deputy Commander For
Nuclear Propulsion

CC:
SUPSHIP, Groton
NRRO, Groton

ectric Boat Division
Main Point Road, Groton, Connecticut 06340 • 203 446-5060

April 20, 1974

Admiral H. G. Rickover, USN
NAVSHIPS 08
Naval Ship Systems Command Headquarters
Department of the Navy
Washington, D. C. 20360

Dear Admiral Rickover:

This is to provide you with what we consider the significant points raised during the visit of Don L. Lynch and George H. Foster, Jr. of the staff of the Senate Armed Services Committee during their visit to Electric Boat Division on April 18, 1974.

The Staff Members arrived in Groton in the company of Cdr. Lardis and were met by J. D. Pierce and Captain O'Keefe and the party proceeded to Pierce's office for the meeting, where they were joined by Mr. Curtis. Mr. Foster immediately advised Captain O'Keefe to leave as he wanted to talk privately with the contractor. Captain O'Keefe offered any service to the Staff they might desire and departed with Cdr. Lardis.

The following points summarize the major convictions and/or questions presented by the Staff:

a. Resources are not available for construction of additional SSN688 ships.

b. Shipyard manpower is not available to meet expanding shipbuilding requirements.

c. They had no knowledge that Electric Boat Division was to lease the Quonset Point property, therefore had no understanding of the flexibility and expansion capabilities this afforded.

d. Funding of additional SSN688s could be delayed a year and long lead material authorized without any interruption of the program.

e. Construction authorization for new programs should be delayed until the detailed design is complete.

f. Questions were raised relative to the excessive amount of paperwork required by the Navy.

g. What major problem did we experience working to Newport News' design.

h. There was extensive questioning of the construction lead time for SSN688 plans and material.

Throughout the visit of the Staff, we made the following points:

a. The major manpower buildup for the projected Electric Boat Division growth at Groton has already been accomplished and we have made substantial advances in improving the effectiveness of our training of new personnel.

b. Electric Boat Division is not having any trouble hiring additional people as required.

c. Future growth at Quonset Point will be effective because of the 6,000 manufacturing personnel in the Rhode Island area currently unemployed. Electric Boat Division has 181 people working and 159 in training currently at Quonset Point with 2,000 applications having been made with no advertising.

d. Quonset Point provides more space available to Electric Boat Division than the size of our current shipbuilding activity in Groton. This will provide greatly increased flexibility and expansion capability beyond that required for the projected programs.

e. Electric Boat Division planning is based on $1\frac{1}{2}$ TRIDENTS and 3 SSN688s per year even though our land level construction facility could accommodate 2 TRIDENTS per year.

f. Electric Boat Division planning is based on follow-on SSN688s as a continuation of the three ship per year program underway. This program is strictly internal planning by Electric Boat Division and does not reflect total capacity.

g. Electric Boat Division has no information as to the required construction dates for the Fiscal 1975 submarines. However, we do feel that once the program is underway we could accommodate earlier construction for follow-on SSN688s utilizing the land level construction or shortening SSN688 construction times as we have done with the SSN637 Class.

h. Electric Boat Division cannot provide information as to the long lead time material requirements for Fiscal 1975 submarines. This must come from the Navy.

i. Steel must be ordered at least two years prior to keel laying for submarines at Electric Boat Division. In addition, the lead times for submarine components has doubled in the past two years. We anticipate additional lengthening of lead times. Therefore, it is essential to the program that authorization for future ships be provided early enough to keep the material pipeline for future SSN688s flowing without interruption.

j. Electric Boat Division does not have problems that the rest of the industry expresses in working with the Navy because Electric Boat Division and the Navy work hand-in-glove from conceptual design through the construction phase. This assures that we are a party to the establishment of requirements to which the ships are built.

k. The required documentation to assure meeting the nuclear and submarine safety requirements requires a great deal of paperwork. We have no recommendations relative to the elimination of Navy paperwork.

l. The cheapest way to conduct a submarine program is to build the ships in the shortest possible time. This necessitates construction starting as soon as possible. Our experience is that construction should start when less than 5% of the plans are available, with 20% available at keel laying and 80% available at launch. Over a period of years, we have worked in this fashion without excessive contract changes and it has proven to be the most cost effective program.

m. We have had no major problems working with Newport News' design. While certain of their details are different than we are used to, we have been able to accommodate them.

Since the Staff members seem to be convinced that their position was correct, we do not feel that we changed their mind. However, we do believe that we injected some doubts into their thinking.

Respectfully,

M. C. Curtis
Deputy General Manager

J. D. Pierce
General Manager

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
15 November 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Decision by the Court of Claims in the General Dynamics Corporation case (No. 267-70) as a basis for Government appeal of the decision by the Armed Services Board of Contract Appeals in the Litton "Project X" case (ASBCA No. 17579).

Ref: (a) My memo to you dtd 26 Apr 1978; Subj: Proposed $31 million payment to Ingalls Shipbuilding Division of Litton Industries on "Project X" decision (ASBCA decision No. 17579)
(b) My memo to the Deputy Secretary of Defense dtd 3 May 1978; Subj: Government's right of appeal from adverse Board of Contract Appeals decisions
(c) My memo to the Secretary of the Navy dtd 12 May 1978; Subj: Government's right of appeal from adverse Board of Contract Appeals decisions
(d) Your memorandum dtd 4 May 1978 for the Deputy Secretary of Defense

1. The purpose of this memorandum is to call your attention to a recent Court of Claims case, General Dynamics Corporation v. U.S., No. 267-70 decided October 18, 1978, and to recommend, on the basis of the Court's ruling, that you request the Justice Department to appeal the decision of the Armed Services Board of Contract Appeals (ASBCA) in the "Project X" case (Appeal of Ingalls Shipbuilding Division, Litton Systems Inc., ASBCA No. 17579).

2. In large part, Litton's Project X claim is based on the "impact" or "ripple" theory of entitlement. Litton claimed that Navy responsible actions under three submarine contracts increased costs by $131.5 million on various other contracts to build five Navy surface ships and 14 commercial vessels. Litton requested that the price of the submarine contracts be increased to pay for the costs claimed. Historically the Government has taken the position that a contractor cannot charge the Government under one contract for alleged impact and resultant costs incurred on another contract. However, on February 17, 1978, the ASBCA ruled in favor of Litton on this issue and, for the first time, recognized Government liability for ripple or impact costs. Accordingly, Litton was awarded $50.4 million.

3. In references (a), (b) and (c) I recommended to you and to the Deputy Secretary of Defense that the Government should appeal the Litton decision. You disagreed. In reference (d), you explained to the Deputy Secretary of Defense why you decided not to appeal the Litton decision. You questioned "whether the Secretary himself can either disregard or seek court review of an ASBCA decision". You also expressed your view that it would be unwise, unfair and arbitrary for the Secretary to attempt to appeal an adverse ASBCA decision in the absence of fraud or the equivalent. The Deputy Secretary accepted your recommendation. On May 9, 1978, the Board reaffirmed its original decision, and the Navy, at your direction, paid Litton the full $50.4 million.

4. Several weeks ago, in a case involving General Dynamics, the Court of Claims reached a legal conclusion regarding the impact theory which appears to abrogate the ASBCA's reasoning in Litton. In General Dynamics the Court reaffirmed the legal principle upon which the Navy had traditionally denied impact claims, including the Litton Project X claim. Specifically, the Court found:

> "...there is no general right to equitable adjustment computed by following the cost of change orders in one contract, into another."

The Court further stated that:

> "...only in exceptional circumstances can an equitable adjustment be made for extra cost in performing one contract, caused by the Government doing things it has a right to do, respecting other contracts."

The Court decided that the facts in General Dynamics did not constitute such exceptional circumstances.

5. The General Dynamics case carries added weight because all the members of the Court participated in the decision--a practice followed in cases of particular legal importance--and because the Court ruled unanimously in favor of the Government. Moreover, the Court went out of its way to express its disagreement with the shipbuilder's impact theory. They wrote:

> "We agree with the conclusion reached by the trial judge, but modify and expand his analysis in order to show we have considered and do not agree with the contentions made by plaintiff concerning the liability of the government to absorb the costs at issue."

Had the Court not wanted to refute broad application of the impact theory, it could have simply affirmed the trial judge's opinion which already found for the Government on different grounds. Instead, the Court focused on the impact theory as the deciding question of law.

6. There are striking similarities in the General Dynamics and Litton cases.

- o Both cases involved Navy submarine construction contracts performed in roughly the same time frame with the same pertinent contract provisions.
- o Both cases involved delays growing out of the Submarine Safety Program ("Subsafe") which followed the loss of THRESHER in 1963.
- o In both cases the Navy issued, adjudicated and paid the contractor for Subsafe change orders on the contracts under which the change orders were issued. However, both shipbuilders later claimed additional money for the impact of those adjudicated change orders on other contracts.
- o In both cases there was a judicial finding of fact that the Government-issued change orders had, to some extent, impacted work on other contracts; the legal issue is whether the Government is liable.

7. Navy attorneys, in trying to minimize the applicability of the Litton decision to future claims, contend that the Board's decision in that case hinged on a Suspension of Work clause no longer included in new shipbuilding contracts. In the General Dynamics case, the same clause applies. The Court took note of the Suspension of Work argument as follows:

> "Plaintiff suggests that it would also be possible to characterize the facts as giving rise to a partial suspension and then acceleration under the Suspension of Work and Changes clause."

Apparently, the Court was not persuaded by this rationale, which is central to the ASBCA decision in Litton. I presume the argument was made with equal eloquence in both forums, since the lead attorney on the Litton case also helped represent General Dynamics before the Court of Claims.

8. If the Litton decision is not overturned, the Government will no doubt be plagued by it for years to come. No matter how narrowly Government lawyers try to construe the ASBCA decision, contractors will contend that their situation is similar to that existing in Litton. Of course, contractors can also be expected to argue that the Court of Claims decision in General Dynamics recognizes "rare cases" of Government liability for impact costs and that their situation falls into that category. The Court indicated that the few exceptions should, in fact, be rare, citing only:

> "...those of concealment from the plaintiff, when it bids, of already formulated plans and intentions respecting other contracts, which plans and intentions the plaintiff needs to know to estimate its costs, possibly some instances of intentionally and knowingly hindering the plaintiff in doing the contract work, and perhaps other instances where some degree of government culpability and 'proximate cause' exist."

9. Based on General Dynamics, Litton would not seem to qualify under the "rare cases" and "exceptional circumstances" laid down by the Court of Claims. The Navy has a right to find out. The only way to do so is to appeal the Litton decision.

10. In my judgement, no stimga will attach to Government appeal of the Litton decision even though the Board's judgement has been paid by the Navy. As you know, the Wunderlich Act provides that no decision of an administrative official or a board may be final on a question of law. Also the Contract Disputes Act of 1978 affirms the principle of Government appeal of adverse decisions by administrative boards. The Justice Department recognizes the right of an agency to renounce a decision of its own board of contract appeals. Presently at least two such cases are pending in Federal court--Fishback & Moore v. U.S. (petition filed 8/16/78) in which the United States Information Agency (USIA) has renounced a decision of the ASBCA; and Pierce Associates v. U.S. (petition filed 8/24/78) in which the General Services Administration (GSA) has renounced a decision of its board of contract appeals.

11. In the Litton case the Board has apparently erred in a question of law. Moreover, the Board's decision will eventually encourage other contractors to pursue impact claims against the Government. Unless reversed, the Board will be prone to pass on these claims based on its own legal reasoning in Litton.

12. Based on the above, I strongly recommend that the Government appeal the Litton decision to the Court of Claims. The statute of limitations has not expired for appealing Litton. Therefore, timely action by the Navy may well save the Government an immediate $50.4 million and probably much more over the long run. By correcting the ASBCA errors of law now, the Government will discourage future impact claims and associated litigation. Such action will also be in line with Presidential directives (1) to eliminate unnecessary spending, (2) to see that Government agencies do not pay more than is warranted for their needs, and (3) to do everything possible to limit inflation. Unnecessary Government expenditures are, as you surely recognize, inflationary.

13. I would appreciate being informed of the action you take in this matter.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Manpower, Reserve Affairs and Logistics)
Chief of Naval Operations
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
15 November 1978

MEMORANDUM FOR THE DEPUTY SECRETARY OF DEFENSE

Subj: Decision by the Court of Claims in the General Dynamics Corporation case (No. 267-70) as a basis for Government appeal of the decision by the Armed Services Board of Contract Appeals in the Litton "Project X" case (ASBCA No. 17579).

Ref: (a) My memo to you dtd 3 May 1978; Subj: Government's right of appeal from adverse Board of Contract Appeals decisions
(b) Secretary of the Navy memo to you dtd 4 May 1978
(c) Your memo to me dtd May 20, 1978

Encl: (1) My memo for the Secretary of the Navy dtd 15 Nov 1978; Subj: Same as above

1. In reference (a) I recommended appeal of the Armed Services Board of Contract Appeals decision in the Litton "Project X" case to the Court of Claims. The Secretary of the Navy in reference (b) disagreed. By reference (c) you informed me you had accepted his position.

2. Last month the Court of Claims issued a decision in a similar case involving General Dynamics. That decision indicates that the Armed Services Board of Contract Appeals made a serious and costly mistake on a question of law in the Litton case. If so, the company would not be entitled to the $50.4 million judgement awarded by the Board.

3. Enclosure (1) explains in greater detail the significance of the Court of Claims decision in relation to the Litton case. Based on the Court's action, I again urge that the Government appeal the Litton decision to the Court of Claims.

H. G. Rickover

Memo to the Deputy Secretary of Defense

Copy to:
Secretary of the Navy
Under Secretary of the Navy
Assistant Secretary of the Navy
(Manpower, Reserve Affairs and Logistics)
Chief of Naval Operations
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
19 May 1979

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Proposed meeting between Navy officials and senior shipbuilding executives concerning the Naval Ship Procurement Process Study

Ref: (a) My memo to you dtd 28 June 1978

1. I understand that on 21 May 1979 Assistant Secretary Hidalgo and others will meet with senior shipbuilding executives to discuss progress to date in implementing recommendations of the Naval Ship Procurement Process Study (NSPPS). The purpose of this memorandum is to point out possible pitfalls of the proposed meeting, and to recommend additional subjects which should be covered with those who attend.

2. In reference (a), I pointed out that the Naval Ship Procurement Process Study does not present a realistic view of problems which face the Navy in acquiring ships--especially the claims problem. The Study seems to assume that past claims were largely valid and resulted mainly from shortcomings in Navy procurement policies and practices. To my knowledge, none of the Study group evaluated actual claims or compared them with the facts as determined by Navy analysts. Had the Study group done so, they might have discovered they were operating from an unsound premise.

3. In its Report on the Department of Defense Appropriation Authorization Act, 1979, the House Armed Services Committee alluded to many of the fundamental problems the Navy must address in conducting future business with shipbuilders. The Committee stated:

> "In conducting future business the committee considers that the Navy should follow its own policies for the prompt identification and settlement of claims. It should insure that contracts are, in fact, administered on a pay-as-you-go basis and that appropriate safeguards are in effect to preclude anyone except an authorized contracting officer from issuing a contract change to a Government contract. The Navy should also enforce its requirements for the certification of claims and reject claims that are not properly substantiated."

4. There is a widespread public perception that deficient Navy procurement practices caused the claims problem of the past decade. I am concerned that the Navy Secretariat may be furthering that misconception by placing so much emphasis on Navy efforts to implement the Study without at the same time emphasizing the shipbuilders' responsibility to change their practices. It will make matters worse if shipbuilders leave Mr. Hidalgo's meeting next week with the impression that the Navy assumes primary responsibility for past claims and that the shipbuilders themselves are free to submit more claims of the sort recently settled. Moreover, Members of Congress and the public will no doubt infer that through implementation of the Study recommendations the Navy has taken effective steps to preclude such claims. When they recur, the Navy will again be accused of mismanaging its shipbuilding program.

5. As you know, the Navy cannot unilaterally eliminate claims. To imply otherwise defeats what we are all trying to achieve--namely, the elimination of omnibus, inflated, after-the-fact claims. That is why I believe that at the upcoming meeting Navy officials should also emphasize the responsibilities of shipbuilders in this matter.

6. To my knowledge, shipbuilders have made no commitment to honor future contracts; to confine their claims to legitimate items; or to cooperate with the Navy in ensuring that contracts are administered on a pay-as-you-go basis. I recommend therefore that at the upcoming meeting Navy officials give equal time and attention to what is expected of shipbuilders, rather than focusing strictly on Navy initiatives. Specifically, Navy officials should make clear that:

a. The Navy intends to administer contracts on a pay-as-you-go basis. To accomplish this, shipbuilders must fully price and resolve changes as they arise, and comply with the claim notification provisions of their contracts.

b. Shipbuilders must confine their proposals for changed work to the merits of the change. The Navy will pay the legitimate cost of changes, but not arbitrary and unsubstantiated factors layered on these costs. Some shipbuilders are trying to "game" the Government.

c. False and inflated claims waste thousands of hours of effort by Navy personnel. To discourage such waste, the Navy will carry out its responsibilities by seeking enforcement of the applicable United States statutes governing such matters.

d. Shipbuilders must stop using inflated claims to book more favorable profit and loss figures for stockholders. In the past, financial reporting considerations have been an impediment to settlement of claims on their merits. If this problem persists, the Navy will seek enforcement of remedies through the Securities and Exchange Commission.

e. The Navy will invoke the Defense Production Act or other statutes to preclude disruption of urgent defense projects by contractors who stop work in order to gain leverage in contract disputes.

7. In its Report on FY 1979 Department of Defense Appropriations, the Senate Armed Services Committee expressed concern that the Navy might be tempted to deal with the claims problem by shifting more financial risk to the Government. The Committee stated:

> "...Changes are being made in contracts with the purpose of preventing a recurrence of the claims problem. However, proposed contracting changes may serve only to unnecessarily transfer risk and cost from the shipbuilder to the government. Should this happen, claims may be for the most part eliminated, however, cost growth and escalation could not only remain but possibly increase--cosmetic changes are not satisfactory. Contract clauses are not an adequate substitute for prudent and proper management...."

8. The Naval Ship Procurement Process Study appears to be headed in a direction opposite the Senate Armed Services Committee report. The Study seems to advocate writing contracts so that more and more situations that arise during performance of the contract entitle the contractor to contract price increases. With respect to clauses to be used in future shipbuilding contracts the Study states:

> "The clauses should reflect a balance of risk which places most, if not all, of the risks outside of the control of the shipbuilder on the Navy, thereby permitting the shipbuilder to focus attention on managing those aspects of the work over which it has control."

In this regard the Study suggests consideration of a clause which would entitle shipbuilders to price reopeners for costs "arising from causes beyond the control and without any fault or negligence of the contractor...."

9. Navy shipbuilding contracts are already more liberal than other defense and commercial contracts in protecting shipbuilders from the financial consequences of events beyond their control. To go further in this direction would create an even more fertile field for claims lawyers. Obviously, determining what a shipbuilder can or cannot control is highly subjective; e.g., a strike, manpower and productivity problems such as those involved in the recent claims, etc. Contractors faced with cost overruns would be able to exploit these price reopeners to effectively convert fixed priced contracts into cost-plus. Moreover, when the terms and conditions of Navy shipbuilding contracts are more liberal than in commercial contracts, shipbuilders have an inherent financial incentive to give priority to the commercial work. If additional costs then ensue, they are incurred under Navy contracts, where they can be more easily recovered. For example, during the recent strike at Newport News, the company transferred much of the manpower available for the CVN 70 to meeting commitments on a commercial contract. This will increase the cost of the CVN 70 to the Navy.

10. Navy officials should make it clear at the meeting that the Navy does not intend to assume more risks or provide more price reopeners in fixed priced shipbuilding contracts.

11. In testifying on the recent PL 85-804 settlements, you pointed out that no contract clause or procurement procedure can substitute for the good faith determination of the parties to avoid claims. I agree. The proposed meeting on 21 May 1979 affords shipbuilders an opportunity to demonstrate that they match the Navy's determination in this regard.

12. I would appreciate being informed of the results of the 21 May meeting particularly with respect to the items I have discussed in this memorandum; also whether my suggestions are of use to you.

H.G. Rickover

Copy to:
Assistant Secretary of the Navy
(Manpower, Reserve Affairs and Logistics)
The General Counsel of the Navy
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
28 Aug 1979

MEMORANDUM FOR THE GENERAL COUNSEL OF THE NAVY

Subj: Certification of CGN 41 Cost and Pricing Data

Encl: (1) Newport News ltr dtd 24 Aug 1979

1. I have just had the opportunity to review a certificate proposed by Newport News concerning CGN 41 data it submitted. The data was submitted to support the CGN 41 negotiations conducted between the Navy and Newport News which led to the Justice Department accepting a settlement of the litigation with Newport News. Personnel from your office are now attempting to incorporate the settlement into a modification to the Navy's contract with Newport News for construction of nuclear powered cruisers.

2. The Newport News proposal would only certify that a few documents, specifically identified, were provided to the Contracting Officer or his representative and that the documents are "true copies" of current reports, forecasts or estimates. This proposed certificate does not appear to extend to the contents of the documents.

3. The settlement agreement between the Justice Department and Newport News contains a price for construction of the CGN 41. The price was based on the estimated cost at completion for the CGN 41 to which the parties agreed several months ago. In arriving at the estimated cost at completion the parties made extensive use of cost and pricing data provided by Newport News. Since the Government relied on the data provided by Newport News in agreeing to the price to be included in the CGN 41 contract modification, Newport News should be required to certify the accuracy of the data.

4. It has been argued that the Government is not required to obtain a Truth-in-Negotiations Act certificate for contract modifications implementing settlements of litigation by the Justice Department. Regardless of the legal argument, the Government is not precluded from obtaining such a certification. There does not appear to be any reason for the Government to establish a lower standard of cost and pricing data certification for a contract modification resulting from a litigation settle-

ment than is required for any other contract modification. Moreover, the draft contract modification, as currently written, reserves the Government's rights against the contractor under the Truth-in-Negotiations Act only "to the extent that the Certificates of Current Cost and Pricing Data have been provided in connection with this modification." Failure to obtain a proper certification of cost and pricing data could render this provision meaningless.

5. I recommend that you require Newport News to certify the cost and pricing data submitted in conjunction with the CGN 41 settlement negotiations. In addition to firming up the basis of this settlement, you would facilitate the Government's handling of other certification problems with Newport News. Enclosure (1) represents Newport News' new interpretations of the certificates required by the Truth-in-Negotiations Act, the Contract Disputes Act, the 1979 Authorization Act and other requirements. Newport News appears to have taken great liberty in redefining the intent of Congress, the words of the statutes and the words contained in the certifications in such a manner as to greatly reduce their effectiveness.

6. I would appreciate being advised of your actions concerning this matter.

H.G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Sea Systems Command
Counsel, NAVSEA
Deputy Commander for Contracts, NAVSEA

Newport News Shipbuilding
A Tenneco Company

4101 Washington Avenue
Newport News, Virginia 23607
(804) 380-2000

TENNECO

Contracts/GEN

August 24, 1979

Supervisor of Shipbuilding
Conversion and Repair, U.S. Navy
Newport News Shipbuilding and Dry
Dock Company
Newport News, Virginia 23607

Attention: Contracting Officer

Subject: Certification of Claims

Reference: SUPSHIP-NN letter GEN/4330, Serial 410-123
Dated April 5, 1979

Dear Sir:

The referenced letter transmitted a summary of various certifications which you consider this Company is required to submit by contract and/or regulation. Our interpretation of these requirements is as follows:

1. CERTIFICATES OF CURRENT COST AND PRICING DATA

Certification of cost and pricing data described by Public Law 87-653 is to be submitted as provided by Defense Acquisition Regulation (DAR) 3-807.6. DAR 3-807.6 states, "The Contractor shall be required to submit only one certificate which shall be submitted as soon as practicable after agreement is reached on the contract or modification price." (Emphasis added.) Certificates will be submitted when required by this regulation.

2. CERTIFICATION OF REQUESTS FOR EQUITABLE ADJUSTMENT

Certification described by the contract clause incorporated in certain contracts titled "Documentation of Requests for Equitable Adjustment" states in part:

> "I, _____*_____, the responsible senior company official authorized to commit the _____**_____ with respect to its claim." (Emphasis added.)

> ". . . if such individual is authorized to commit the corporate entity which is a party to the contract which the claim is asserted. (Emphasis added.)
>
> "Name of corporate or other business entity submitting claim. (Emphasis added.)
>
> "Each proposal submitted in support of a claim for equitable adjustment . . . shall contain a duly executed DD Form 633.5 with respect to each individual claim item." (Emphasis added.)

Thus, the language of the certification as set forth in the contract clauses is restricted to claims. A claim is defined by Section 7-103.12 of the Defense Acquisition Regulation (implementing the Contract Disputes Act of 1978) as follows:

> "'Claim' means
> (1) a written request submitted to the Contracting Officer;
> (2) for payment of money, adjustment of contract terms, or other relief;
> (3) which is in dispute or remains unresolved after a reasonable time for its review and disposition by the Government; and
> (4) for which a Contracting Officer's decision is demanded."

If in the past there has been any confusion as to the definition of a claim, this has been clearly resolved by the statutory and regulatory imposed definition. A claim does not come into existance, and consequently no claim has been submitted, until such time as a final decision has been demanded. On a case basis, we will elect to either submit certifications for such claims as required by contract clauses or by the Contract Disputes Act of 1978. Section 16 of this Act permits contractors to elect to proceed under the Act for contracts awarded prior to March 31, 1979, notwithstanding any contract provision which might be to the contrary.

3. CERTIFICATES UNDER WAGE AND PRICE STANDARDS

Certification under the Wage and Price Standards will be submitted as required by current regulation.

4. CERTIFICATES UNDER THE CONTRACT DISPUTES ACT OF 1978

Certifications under the Contract Disputes Act of 1978 will be submitted at the time a request is submitted as a claim as the term "claim" is defined by the regulations implementing the Act. (See paragraph 2 above.)

5. CERTIFICATES UNDER THE DOD APPROPRIATION AUTHORIZATION ACT, 1979

We believe the certification requirement in the 1979 DOD Appropriation Authorization Act (Authorization Act), applicable only to funds authorized by that Act or any other Act authorizing 1979 funds, was only an interim and temporary measure taken by Congress pending implementation of the Contract Disputes Act. To apply the Authorization Act to "all funds" would create constitutional problems with previously existing contracts, and the Contract Disputes Act (and its legislative history) clearly indicate it was intended to be all encompassing and the "last word" of Congress on matters relating to the resolution of disputes in future contracts. In any event, Congress was addressing the same concern in both Acts, and we see no inconsistency in the Acts so long as the Authorization Act is not given retroactive application and the regulatory definition of a claim, cited above, is utilized.

When a Contract Disputes Act certification is required, a duplicate Defense Authorization Act certification need not be provided (see DAR 7-104.102). In the unlikely event we have a claim submitted under a contract funded with 1979 authorizations and executed prior to the effective date of the Contract Disputes Act, we will certify such claim pursuant to the Defense Authorization Act at the time of submission as a claim as defined above.

6. SUBMISSION OF PROPOSALS

Prior to the submission of a proposal as a "claim", "requests for equitable adjustment" (or a demand for a final decision, payment, or contract adjustment), we propose to continue submitting our proposals for your consideration, evaluation, and negotiation. As in the past, these proposals can serve as a sufficient basis for resolving matters by mutual agreement and negotiation without the necessity of submitting a claim.

7. INTERPRETATION OF CERTIFICATES

When a claim is submitted and certification is required, we feel it is important that the meaning of the required certification be fully understood by the parties. Our primary concern is that we

know what is required and expected. In general, we do not feel that the certification requirement, reasonably interpreted as defined below, should result in any requirement different than normally expected of a party in litigation. We would not consider such an interpretation a "change" in our contractual requirements. This interpretation assumes that the certificate will be interpreted under a rule of reason which considers the magnitude and difficulties of the task in preparing major claims under shipbuilding or overhaul contracts. With respect to specific terms of the certificate, the Company's interpretation is as follows:

(a) "Good Faith" - "Good faith," as used in this certificate, means that the official executing the certificate has no knowledge of any intent on the part of the contractor to mislead or deceive the Government.

(b) "Supporting Data" - Our claims are generally comprised of (1) a proposal narrative, (2) cost estimate, and (3) factual data, explanatory material, estimates and opinions submitted in support of the proposal narrative and cost estimates. The term "supporting data" as used in the certificate refers only to factual data and does not encompass estimates, opinions, or matters of judgment.

(c) "Accurate" - The term "accurate" as used in the certificate does not mean that the claim will be entirely free of errors of fact. It is an implicit condition of the certificate that it is reasonable to expect inaccuracies or mistakes in any large claims preparation effort. We do represent that we have made a reasonable effort to avoid error, and if any significant mistakes are discovered they will be corrected in a routine manner.

(d) "Complete" - The term "complete" as used in the certificate must be interpreted within the framework of advocacy. It means that we have attempted to the best of our information and belief to completely set forth all those significant facts which, in our opinion, are relevant to our theory of entitlement, but no attempt has been made to support or rebut Navy defenses not yet formally presented. Likewise, no attempt has been made to include information or data with which we disagree or in our judgment is inaccurate and therefore irrelevant.

(e) "The contractor believes the Government is liable" means that while we believe the Government should be held liable for the full amount claimed, we do not represent that we believe we will ultimately recover the full amount claimed. Amounts claimed may not be based on the current weight of legal authority, and untested legal theories may be utilized. Specifically, we believe any litigant should have the opportunity to try to convince a court to change bad law or create new law as appropriate.

Supervisor of Shipbuilding August 24, 1979

Without limiting the conditions and interpretations outlined above, the certificate is not intended to mean that the Company will be forever estopped from modifying any submitted claim. It is understood that such modification may be necessary to meet and overcome Government defenses as they may be developed or asserted, as well as to correct errors, omissions, or mistakes to ensure that the Company receives adjustment of its contracts to the fullest extent to which it may be entitled.

If you agree with the above, we would appreciate acknowledgement of that understanding. If you do not agree, or if there is something you do not understand which needs clarification, we would like to be advised of the specific area of disagreement or concern and discuss that matter with you or representatives.

Sincerely yours,

J. Kondo

Vice President

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
30 Oct 1979

MEMORANDUM FOR THE DEPUTY SECRETARY OF DEFENSE

Subj: Proposed Office of Federal Procurement Policy Regulation to implement the Contract Disputes Act of 1978; recommendation concerning

Ref: (a) Office of the Under Secretary of Defense memo dtd 15 October 1979

Encl: (1) Excerpts from a letter to the members of the American Bar Association's Public Contract Law Section as it appears in the January, 1979 issue of the Public Contract Newsletter

1. Reference (a) transmitted to the military services and other defense agencies the latest in a series of proposed regulations prepared by the Office of Federal Procurement Policy (OFPP) to implement the Contract Disputes Act of 1978. Reference (a) notes that various Department of Defense offices have been at odds with the OFPP position; that the Deputy Under Secretary of Defense (Acquisition Policy) met with a representative of the OFPP to discuss the issues and resolve the differences; and that any negative comments to the proposed OFPP regulations "should be accompanied by constructive alternatives."

2. The proposed regulation forwarded by reference (a) would substantially weaken the Government's hand in its efforts to preclude or defend against large, grossly inflated claims of the type that plagued the Navy through the 1970's. Instead of discouraging such claims, the proposed regulation would pave the way for claims lawyers to seek for their clients claim settlements in excess of amounts the Government legally owes.

3. The proposed regulation would turn the Contract Disputes Act on its head. It resurrects concepts that were specifically rejected in Congress and eliminated from previous versions of the bill. Conversely, provisions included in the Act as safeguards (such as the requirement for claims certification) would effectively be nullified by the proposed regulation.

4. If the proposed regulation is issued in its present form, the DOD and other Government agencies will become more vulnerable than ever to grossly inflated claims, threats of contractor work stoppage, and contractor attempts to settle their claims

independent of their merits by horsetrading with Government officials who are not familiar with the details of the dispute. These are the very problems that have consumed so much of your time and Navy resources in connection with the recently settled shipbuilding claims.

5. While the language and history of the Contract Disputes Act reflects a clear intent to put a stop to such practices, the proposed OFPP regulations instead encourage them. It appears that claims lawyers themselves played an important role in drafting the proposed regulations. The three major problem areas are discussed below:

a. Claims certification. To discourage unsubstantiated and grossly inflated claims, Congress inserted a provision in the Contract Disputes Act requiring contractor certification of claims. However, by inventing a new definition for the word "claim," the proposed regulation largely nullifies this requirement. Under the OFPP definition, a claim means a written submission by a contractor, made after the parties have had "...a reasonable time to reach agreement."

This OFPP definition would enable the contractor to control the time when his claim becomes a "claim" for purposes of the Contract Disputes Act. Prior to that time, the Government would apparently be expected to try to evaluate and settle a non-claim. Such an arrangement would impose on the Government the burden of evaluating exaggerated or frivolous claims which contractor officials are unwilling to certify. This is contrary to the plain intent of the claim certification provision in the Contract Disputes Act. By the proposed OFPP definition, it appears that the Navy has never had a "claims" problem; the Newport News claims that totaled $894 million would not be defined as "claims"--neither would the $544 million in claims submitted by Electric Boat. Yet these shipbuilding claims were the heart of the highly publicized Navy claims problem that attracted so much attention in the press and in Congress. The Contract Disputes Act certificate must be submitted at the outset if it is to have any effect in deterring submission of exaggerated or frivolous claims.

These shipbuilding claims tied the Navy in knots for many years, as the companies threatened to stop work on urgent defense projects in their attempts to force claim settlements on their terms. As Secretary of the Navy, you referred many of these claims to the Justice Department for investigation of possible violation of Federal fraud and false claim statutes. As a result many of them are currently being investigated by Federal Grand Juries.

The proposed OFPP definition of claims may also cause the Government problems beyond the Contract Disputes Act. Already, there have been efforts to use a prior OFPP claim definition in an attempt to postpone similar certification requirements of the 1979 Defense Authorization Act, despite the fact that the Act states explicitly that the certification is required at time of submission of "any contract claim, request for equitable adjustment to contract terms, request for relief under Public Law 85-804, or other similar request."

My recommendation: The DOD should insist that the claim certification requirements of the Contract Disputes Act are to be applied upon initial submission of the contractor's request--before the Government has to undertake the task of evaluating the claim.

b. Right to stop work on defense contracts. As you well know from your experience with shipbuilding claims, contractors were unwilling to settle claims on their merits whenever doing so would require them to report a loss. To do so would reveal to their stockholders and the public (prospective purchasers of their stock) that previously published profit projections had been overly optimistic in anticipation of receiving more from their claims than what they actually were entitled to. By dragging out contract disputes and demanding more than the Navy actually owed, contractors were able to perpetuate these overly optimistic profit reports.

Some shipbuilders, in spite of optimistic profit projections, ran into financing problems as their costs were exceeding payments being made by the Navy in accordance with contract terms. In an attempt to relieve their financial problems, they stopped or threatened to stop work. The threat of work stoppage--and in one case, actual work stoppage--forced the Navy to take action, including going to court, to require continued performance. The Navy contended that contractors do not have the legal right to stop work on defense contracts. Although by court order or agreement the Navy ended up financing contractors beyond the terms of the applicable contract, in order to obtain continued performance, it did not accept the principle that the Government has an obligation to provide such extra-contractual financing.

The proposed OFPP regulation, however, opens the door for any Government contractor to obtain Government financing above and beyond the terms of his contract simply by asserting that his claim is beyond the terms of the contract. In such cases, the contractor would be required to continue performance of his contract only if the Government determines that continued performance of work pending final resolution of the claim is essential to national defense, public health or safety; and if the Government provides "reasonable financing."

This provision of the proposed OFPP regulation would largely eliminate any financial incentive contractors have to seek a prompt resolution of their claims. Thus, the proposed regulation makes it possible for contractors to perpetuate contract disputes, regardless of their merit. The proposed regulation is a far cry from the Contract Disputes Act provision that:

> "Nothing in the Act shall prohibit executive agencies from including a clause in government contracts requiring that pending final decision of an appeal, action, or final settlement, a contractor shall proceed diligently with performance of the contract in accordance with the contracting officer's decision."

My recommendation: The proposed regulation should be revised to eliminate any requirement that a contractor's obligation to continue performance of a Government contract is in any way contingent on determinations of essentiality or provision of financing other than that called for in the contract itself.

c. Settlement of claims independent of their merits. The bill which ultimately became the present Contract Disputes Act included a carefully worded and subtle loophole which would have opened the door to extra-contractual settlements without recourse to the requirements and safeguards of the present Public Law 85-804. Government agencies presently do not have this authority except as specifically provided for by Public Law 85-804. That statute permits extra-contractual settlements by the Department of Defense, but only in cases where a Secretary of one of the military services determines that extra-contractual relief is necessary to facilitate national defense. Even then, the law requires prior Congressional review of any such settlements over $25 million.

Another provision of the bill as proposed would have given contractors the right to an informal hearing of their disputes at a level above the contracting officer. It would also have encouraged settlement at that level prior to being considered by the agency's Board of Contract Appeals--the established forum for hearing contract disputes that cannot be resolved at the contracting officer level.

The combination of these proposed provisions would have guaranteed contractors a basis to insist that Congress had intended senior Government officials to negotiate compromise settlements independent of the merits of the dispute.

Concerned that such an arrangement would tend to put undue pressure on Government contracting officers, Congress struck both provisions from the bill. The proposed OFPP regulation, however, attempts to reinstate these very same concepts. Specifically, it states:

> "(b) Government Policy. It is the Government's policy, consistent with the Act, to try to resolve all claims by mutual agreement at the Contracting Officer's level, without litigation. In appropriate circumstances, before issuance of a Contracting Officer's decision on a claim, informal discussions between the parties, to the extent feasible by individuals who have not participated substantially in the matter in dispute, can aid in the resolution of differences by mutual agreement and should be considered. (emphasis added)
>
> "(c) Contracting Officer Authority. Except as provided herein, the Contracting Officer is authorized (within any specific limitations in his warrant) to decide or settle all claims relating to a contract subject to the Act."

It would be wrong to establish an informal settlement forum above the contracting officer. The Boards of Contract Appeals were established for the very purpose of gathering facts and rendering judgments on disputes that cannot be resolved at the contracting officer level.

Establishing an informal forum for claim settlements would encourage settlement of contract disputes by horse-trading. There would be no procedure for determining the facts and the principal qualification for Government participation would be the lack of prior involvement in the matter under dispute. This would require the

Government to be represented by individuals without knowledge of the issue. Can one imagine that a contractor would agree to have his interests represented by persons ignorant of the facts?.

My recommendation: Revise the proposed regulation to make it clear that Government contracting officers must be able to substantiate entitlement in any proposed settlement amount. If entitlement in the amount demanded by the contractor cannot be shown, and if a formal decision is not made to grant extra-contractual relief, litigation must be the next step. The proposed regulation should be further revised so that it does not encourage contractors to take their disputes to higher level Government officials or to others "who have not participated substantially in the matter in dispute." By their right to appeal contracting officer decisions to Boards of Contract Appeals or to the courts, contractors are protected against arbitrary or capricious actions on the part of contracting officials.

6. The history of the Contract Disputes Act illustrates how special interest groups are able to establish effective control over Government policy in areas that affect them. In fact, the legislative proposals upon which the Contract Disputes Act was based were written and promoted by the American Bar Association (ABA). Within the ABA, the issue was handled by the Public Contract Law Section; and within that Section, by the very claims lawyers who have been prosecuting large claims against the Government. They sought to strengthen their hand in disputes with the Government through one-sided contract disputes legislation.

7. The January 1979 newsletter published by the ABA's Public Contract Law Section included a letter from the then Chairman of the Section reporting on its activities in connection with the recently enacted Contract Disputes Act. His letter reflects the displeasure of the claims lawyers when Congress eliminated loopholes from the ABA-sponsored bill, added strict provisions requiring claim certification, and prescribed heavy penalties for deliberate submission of false claims. In this letter to his members, the Chairman made it clear that the Public Contract Law Section would endeavor to influence the implementing regulations so as to overcome or lessen "what many in our Section perceive to be serious shortcomings." The proposed OFPP regulation is essentially what the claims section of the ABA wants.

8. The Navy shipbuilding claims experience has highlighted the need for improved safeguards against grossly exaggerated claims. Congress recognized this and through the Contract Disputes Act provided some added protection for the Government.

But if the proposed OFPP regulation is implemented, the Government will be even more vulnerable to protracted contract disputes and unfounded claims.

9. For the above reasons, I strongly recommend that you take the following action:

a. Make it clear to the Office of Federal Procurement Policy (OFPP) that the DOD does not concur with the latest version of the proposed OFPP regulation, notwithstanding any informal discussions or agreements reached heretofore.

b. Request the OFPP to redraft the proposed regulations as recommended in paragraph 5 above. The regulation should: (1) require the Contract Disputes Act certification prior to submission of any contract claim, request for equitable adjustment to contract terms, request for relief under Public Law 85-804, or other similar request. The Government should not be required to evaluate claims which contractor management will not stand behind; (2) eliminate the requirement that the Government provide financing irrespective of contract requirements, as a condition of obtaining continued performance of contracts, pending resolution of disputes; (3) eliminate those parts of the proposed regulation which suggest that contract disputes can or should be settled on a basis other than the actual merits of the dispute or by persons other than those who know the facts and have direct responsibility for the contracts.

c. I further recommend that you raise these issues formally with the Director, Office of Management and Budget to ensure that the OFPP does not issue the proposed regulations until they are revised as stated above.

10. I would appreciate being informed of developments in this matter.

H. G. Rickover

Copy to:
Under Secretary of Defense
(Research and Engineering)
Department of Defense General Counsel
Secretary of the Navy
Assistant Secretary of the Navy
(Manpower, Reserve Affairs and Logistics)
Office of Navy General Counsel
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Naval Sea Systems Command Counsel
Naval Sea Systems Command Deputy Commander for Contracts

Excerpts from a letter to the members of the American Bar Association's Public Contract Law Section as it appears in the January, 1979 issue of the Public Contract Newsletter

"In other respects, however, the Contract Disputes Act of 1978 falls short of Association or Section objectives. The explicit authorization of contracting agencies 'to settle, compromise, pay, or otherwise adjust any claim by or against, or dispute with a contractor' was deleted out of concern of potential overlap with the discretionary authority to grant relief solely authorized by Public Law 85-804."* * *

"Many of us are distressed by the addition to the statute of provisions relating to the certification of claims and to fraudulent claims. * * * We are working to assure that the implementing regulations will minimize the opportunities these provisions afford to protract or frustrate the negotiation, compromise and settlement of legitimate claims."

"We were disappointed by the elimination of the provisions for an informal administrative conference for compromise or settlement of claims at a level above the office to which the contracting officer is attached out of concern of abuse by contractors to undermine the negotiation position of the contracting officer. Again we are hopeful that the implementing regulations will restore the substance of this provision."

"Potentially troublesome is the addition of the statutory language (in 6 (b)) that 'Nothing in this Act shall prohibit Executive agencies from including a clause in government contracts requiring that pending final decision of an appeal, action, or final settlement, a contractor shall proceed diligently with performance of the contract in accordance with the contracting officer's decision.' We are concerned that the implementing regulations recognize that in those circumstances in which a contractor is legally entitled to rescind or terminate the contract (e.g., for mutual mistake or material breach) he cannot be required to 'proceed diligently with performance of the contract in accordance with the contracting officer's decision.' We also question the need for this requirement of continued performance in accordance with the contracting officer's decision as a matter of course; and we are searching for guidelines by which to decide which contracts or which kinds of disputes appropriately may be exempted from this requirement.

* * * * * * *

"On balance, I believe the gains achieved by this legislation outweigh what many in our Section perceive to be serious shortcomings. That this legislation has become law is primarily due to the perception and perseverance of Senator Chiles and Congressmen Harris and Kindness. To them we owe and acknowledge lasting appreciation. Many of the shortcomings can be overcome or lessened by the implementing regulations, and in that large task our concerned committees are busily engaged."

Enclosure (1)

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

4 March 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Potential for Navy Shipbuilding Claims

Ref: (a) SECNAV ltr dtd 7 February 1980 to the Comptroller General of the United States
(b) NAVSEA's proposed Navy comments on GAO Report B-196771 dated 10 January 1980
(c) My memorandum dtd 28 June 1978 to SECNAV; Subj: Shipbuilding Claims
(d) NAVSEA ltr dtd 10 April 1979 to SECNAV: Subj: Award of a contract for the construction of two FY 78/79 SSN 688 Class submarines
(e) EB ltr dtd 29 January 1980 to Supervisor of Shipbuilding, Groton
(f) My memorandum dtd 25 January 1980 to SECNAV; Subj: Quality Control Problems at the Electric Boat Division of the General Dynamics Corporation
(g) My memorandum dated 25 February 1980 to SECNAV; Subj: Quality Control Problems at the Electric Boat Division of the General Dynamics Corporation

1. Throughout the past decade Navy officials, in dealing with Congress, frequently blamed claims problems on prior Navy procurement policies and practices, while fostering the impression that the corrective action taken will preclude similar problems in future. When the claims backlog continued to grow -- often through no fault of the Navy -- the Navy lost credibility with Congress and the public.

2. There are indications that the Navy might again be falling into the same trap. For example, in reference (a) you responded to the 10 January 1980 General Accounting Office (GAO) report entitled "Better Navy Management of Shipbuilding Contracts Could Save Millions of Dollars". The GAO report referred to the possibility of future claims at Electric Boat, to which you responded as follows:

> "Beyond that, I believe you will understand, given my role in the settlement of the shipbuilding claims in 1977-78 as well as my participation in the Naval Ship Procurement Process Study of July 1978, that I consider it imperative that every conceivable precaution be taken against the generation of future claims. We are doing

> this in the Navy today and will continue to do so. I therefore consider that no useful purpose can be served by even a passing reference to the expectation of future claims."

Reference (b), the proposed Navy response to this GAO report, creates the impression that the large omnibus claims are a thing of the past:

> "In recent years, the Navy has implemented an extensive program for minimization of shipbuilding claims. It should be noted that with one exception the $2.7 billion claims, settled in 1978, were filed against contracts signed in or before 1971."

3. In reference (c) I explained in detail why the P.L. 85-804 claims settlements, together with implementation of the recommendations of the Naval Ship Procurement Process Study, would not preclude large, inflated claims in future. The purpose of this memorandum is to warn you of mounting problems, particularly at Electric Boat, which strongly suggest the likelihood of such claims; to recommend that Navy officials avoid downplaying the prospect of future claims; and to urge that the Navy reinforce its efforts to ensure that shipbuilding contracts are administered on a pay-as-you-go basis.

4. Subsequent to the P.L. 85-804 settlement the Naval Sea Systems Command, NAVSEA, has, in fact, made some progress in reducing the Government exposure to some types of claims. At Electric Boat, for example, an improved procedure for authorizing and promptly pricing repairs to government furnished equipment has been implemented. In addition, NAVSEA has obtained from Electric Boat a claims release covering all drawing revisions, issued prior to December 31, 1978, on the TRIDENT and SSN 688 Class contracts. Further, the General Manager, Electric Boat, has indicated agreement with the NAVSEA criteria for determining which drawing revisions, if implemented, would constitute a contract change. If the company honors its agreement to incorporate these criteria in future contracts, NAVSEA will have taken a significant step toward eliminating drawing revisions as a source of future Electric Boat contract disputes.

5. Despite these efforts, it appears that some shipbuilders are already laying the groundwork for future claims. I believe it is only a matter of time until the Navy will again be confronted with omnibus claims such as those the Navy settled only a year and a half ago under P.L. 85-804.

6. Litton is currently phasing out its submarine overhaul work; the last two ships are scheduled for delivery this year. For many

years, submarine overhauls at Litton have taken longer than equivalent overhauls at any other shipyard, public or private, and have generally cost more. The company is overrunning even its own high cost estimates and has frustrated Government efforts to keep these contracts current. The Supervisor of Shipbuilding, Pascagoula, has already rejected claims totalling $13.3 million on these two ships. The proposals allege Government responsibility for contractor responsible delays; reserve Ingalls' rights to claim further delay; and fail to address a major cause for the ship delays, which was Ingalls' responsibility. The Supervisor has requested the company to properly document its claims and submit one complete proposal per ship covering all delay, without any reservations.

7. At Newport News, I have seen no immediate signs of claims since the settlement. However, company officials, in connection with the CVN 71 negotiations, have been trying to get the Navy to interpret the statutory requirements for claims certifications in such a way as to make them meaningless. The importance Newport News officials have apparently assigned to this matter raises concern about their future intentions regarding claims.

8. At Electric Boat the risk of large, omnibus claims seems high. Electric Boat appears already to be facing substantial cost overruns.

a. The adjusted price of the SSN 688 Class submarines included in the P.L. 85-804 settlement was based on an estimated cost-at-completion figure $100 million less than NAVSEA considered the company would ultimately incur. Under the sharing provisions of the restructured contract, the Navy and the company each absorb half of this $100 million overrun; further, the Navy pays certain cost increases due to inflation. Cost overruns beyond the $100 million, however, are to be at Electric Boat's account. As explained later, the company is now experiencing problems which they did not foresee at the time of the previous estimates, and which therefore would seem to put the company in a potential loss situation.

b. As you are aware, the two FY 78/79 SSN 688 Class submarines awarded to Electric Boat subsequent to the P.L. 85-804 settlement are, by NAVSEA predictions, under-priced. This was explained in reference (d). The Comptroller General, in his recent report, suggested this might be a potential claims situation. Despite NAVSEA's conclusion that the company could not build these two ships for the proposed target costs, Electric Boat officials disagreed, contending that they would realize substantial improvements in productivity. Since award of the FY 78/79 ships, however, Electric Boat has not been demonstrating their projected productivity improvements and have been falling behind in production.

9. Electric Boat has, in recent months, experienced two major problems which have caused additional work and delay on the SSN 688 Class contracts and to some extent have impacted TRIDENT work. These will tend to exacerbate the cost overrun problems mentioned above. The first involved the wide-spread installation of contractor-furnished steel which did not conform with specification requirements. The second involves large numbers of defective welds which have been discovered in ships built and being built by Electric Boat.

10. Following an extensive technical review the Navy has been able to accept the non-conforming steel in most applications. By all conventional standards, the problem appears to be a strictly contractor responsible item under Electric Boat's shipbuilding contracts. Nonetheless, Electric Boat has stated its intention to request compensation for the impact of the non-conforming steel problem under the Government insurance provisions of their contracts.

11. In the case of the defective welds, repairs are being made to ships under construction. Ships already delivered by Electric Boat are being inspected to determine the extent of the problem. Inspections of structural welds made by Newport News and Navy shipyards have not revealed problems of the magnitude of those found at Electric Boat.

12. Electric Boat has taken the position that the Government, by having on-site inspectors at Electric Boat, shares responsibility for the defective welding problem. Specifically, in reference (e) the Electric Boat General Manager formally informed the Navy as follows: "... To sum up, we are deeply concerned that ... the Navy seems to be ignoring its role in the quality assurance process and its share of responsibility for the overall problem." The language of the contract, however, makes it clear that Government inspections do not relieve a contractor from any responsibility regarding defects or other failures to meet contract requirements. It appears, however, that the company is laying the groundwork for a claim some time in the future in which the Government, rather than Electric Boat, will be blamed for the company's cost overruns.

13. It has become increasingly difficult to deal with Electric Boat on a day-to-day basis at the working level. For example, the General Manager, Electric Boat refused to discuss the findings of an evaluation of nuclear propulsion work conducted by NAVSEA personnel at the conclusion of their evaluation. While Electric Boat later responded formally to the written report of the evaluation, the response criticized the report as containing: " .. a sizeable number of items which are subjective, minor or erroneous and which tend to obscure and divert attention from those few items which are both valid and significant." In

references (f) and (g) I sent you copies of correspondence between myself and the Chairman of the Board of General Dynamics concerning Electric Boat's unsatisfactory response to the evaluation of naval nuclear propulsion work at Electric Boat. I am concerned that the company, in its efforts to downplay the very real problems at the shipyard, may be fostering in their work force a casual attitude toward the details of submarine construction.

14. Electric Boat has been promoting new pricing policies for contract changes -- apparently with the objective of exploiting these concepts in future claims. In quoting on contract changes, Electric Boat has been adding to the normal costs additional sums to reflect "Mitigation of Delay." Under this concept, the company has only enough people to perform basic contract work; changes, therefore, create an overload which can be overcome only by expending overtime elsewhere in the yard. The company has proposed to add to the normal costs of a change, additional factors to compensate for this alleged, but unsubstantiated expenditure of overtime and the alleged resultant inefficiencies. Since the factors proposed for so-called "Mitigation of Delay" costs are unsubstantiated, the company could later exploit this concept to almost any amount in future claims.

15. There are, of course, legitimate items of Government responsibility at Electric Boat. In the TRIDENT program, for example, and to a lesser extent on the SSN 688 submarines, there have been problems with government-furnished equipment. I understand that NAVSEA will be trying to settle these promptly. Whether the company will price these out promptly, on their merits, or attempt to delay and combine these effects with the other problems I have mentioned remains to be seen. Their actions in this regard will augur their future intentions.

16. It would, in my opinion, be premature for the Navy Secretariat to get involved at this time with Electric Boat officials in the above problems. NAVSEA is aware of, and working on all of them. It is essential, however, that you not be deluded into believing, or encouraging others, especially Congress, to believe that the P.L. 85-804 claims settlements and the proposals of the Naval Ship Procurement Process Study have insulated the Navy from omnibus claims of the type that have tied the Navy in knots over the past decade.

17. Under the circumstances, the Navy's best defense is to make every effort to administer contracts on a pay-as-you-go basis; to face up to contract issues promptly and individually as they arise and on their merits; and to refrain from raising unrealistic expectations in Congress to the effect that the Navy has "solved" the claims problem. I recommend that you so notify all Navy officials involved in testifying on the procurement process.

18. Because of potential claims problems, I also recommend that you require anyone in the Secretariat or at the NAVMAT level who is contacted by General Dynamics officials in connection with contractual matters to make a written record of what was discussed, and refer the contractor officials to the cognizant personnel in NAVSEA.

19. I would appreciate being informed of the action you take in this matter.

H. G. Rickover

Copy to:
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

13 September 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Shipbuilding Claims at Electric Boat

Ref: (a) My memorandum to SECNAV dtd 4 March 1980, Subj: Potential for Navy Shipbuilding Claims
(b) Electric Boat Ltr to NAVSEA dtd 21 August 1980

Encl: (1) My memorandum to COMNAVSEA dtd 6 Sept 1980

1. In reference (a) I pointed to indications that three major shipyards were setting up the Navy for future claims of the type settled in 1978 under Public Law 85-804. Electric Boat, in particular, was facing increased costs and large ship delays as a result of a high incidence of defective structural welds and widespread installation of steel which did not meet specifications. Moreover, it was evident from the company's approach in conducting day-to-day business and in its negotiations, that it was maneuvering to shift financial responsibility for these problems to the Navy. I recommended that, in testifying to the Congress, you and other Navy officials not create the impression that the PL 85-804 claims settlement and the Navy Ship Procurement Process Study would prevent recurrence of the same type of claims problems as encountered in the past.

2. In reference (a), I also invited attention to Electric Boat statements which indicated that the company might in future attempt to make claims on the Government for the cost of the company's problems with non-conforming steel and welding. The Naval Sea Systems Command pursued the matter, requesting, in writing, that the company identify and submit any claims it had in this area. In response, and only after several follow-up requests, Electric Boat informed the Naval Sea Systems Command by reference (b) that it does, in fact, intend to submit insurance claims for the non-conforming steel and welding problems sometime in the future.

3. Under the Navy's fixed-price incentive shipbuilding contracts, the cost of repairing defective shipbuilding work is treated like any other allowable cost, and shared by the shipbuilder and the Navy. The Navy's total financial liability is limited to the ceiling price of the contract. By claiming coverage under the insurance provisions of its contracts, however, Electric Boat seeks to have the Navy pay all costs allegedly stemming from these problems, plus profit for the company and with no regard to the contract ceiling price. Payment of such insurance claims by the Government would set a far-reaching and unacceptable precedent. It would effectively convert fixed-price contracts to cost-plus.

4. Continued Electric Boat statements in day-to-day correspondence, recent actions taken by the company in its administration of shipbuilding contracts, and the loopholes on which it is insisting in negotiations for future contracts, make it clear the company is looking to the Navy to pay for all problems encountered by the Yard, including those for which Electric Boat itself is responsible. Enclosure (1), for example, describes the refusal by Mr. Veliotis, General Manager of Electric Boat, to honor his formal agreement with the Navy on the handling of repairs to Government furnished equipment. His reneging on that agreement clears the way for Electric Boat to establish repairs to Government furnished equipment as one more area for future claims. Enclosure (1) also summarizes additional areas where Electric Boat is laying the groundwork for future claims.

5. Judging by past experience, I believe Electric Boat will delay submitting insurance or other claims until their technical problems have been solved, and the ships are further along in construction. In that manner, the company can have greater assurance that the amounts claimed will take care of their financial problems. The large problems Electric Boat has experienced by their faulty methods have no doubt pushed the cost of these ships well above the company's estimates. In the case of the SSN 688 Class submarines these estimates had been considered by the Navy to be overly optimistic from the very beginning. The Naval Sea Systems Command is making every effort to have Electric Boat submit promptly whatever claims it may have and provide all information required so that these claims can be evaluated individually and on their merits.

6. As you are aware, Congress has expressed specific interest in the problems of shipbuilding claims, and the resultant delays in ship deliveries. In its report on the FY 1981 Appropriation Bill, the House Appropriations Committee states:

> "Congress went along with the Navy's proposal to settle the claims under P.L. 85-804 in order to wipe the slate clean and avoid the likelihood of years of litigation. However, the decision to do so was with the understanding that it was a one-time settlement and that the Navy and its shipbuilders would take the necessary steps to ensure that future contracts would be kept current so that a situation would not again develop where the Navy was faced with large claims years after the fact. The Committee is aware of Navy efforts to see that problems are identified and settled promptly on their merits and to include in its contracts a notification of changes clause to require that shipbuilders notify the Navy of circumstances perceived to create a constructive change in time for the Navy to take timely management action. The Committee strongly endorses these steps."

7. I believe Electric Boat officials may try to mask their claims efforts by portraying their impending insurance claims as not being actual claims. In this connection, the September 12, 1980 edition of The Hartford Courant quotes an Electric Boat spokesman as saying that no claims have been filed for higher payments on submarine contracts; that he knew of none; and that he knew of none that are anticipated.

8. As I explained in reference (a), it would be improvident of the Navy to play down the claims problems it is actually facing. Consistent with your commitment to Congress to keep contracts current, we must continue to insist on prompt identification and resolution of claims. The Naval Sea Systems Command is taking a firm position in this regard; however, resistance is being met from Electric Boat and Newport News. Therefore, I want to be sure you are aware of what is occurring and recognize that your strong support of the Naval Sea Systems Command will be needed. Such support is essential for you to meet the commitment you made to the Congress.

9. Experience has amply shown that in situations such as this contractors often play off one part of the Navy against another. I therefore recommend that you issue a directive requiring Navy officials to keep accurate records of all contacts or discussions with shipyard officials or representatives, which could bear on future claims. This is particularly important in dealings with Electric Boat and Newport News. The cognizant contracting officer must be promptly and fully informed of any such discussions.

10. Experience has shown that without such complete records the passage of time and the frequent turnover of Government personnel makes it almost impossible for the current officials, who must evaluate claims, to recreate the events as they actually were in order to protect the Navy. The contractors, to the contrary, have complete records and an ample battery of claims lawyers to prosecute their endeavors.

11. I would appreciate being informed of the action you take in this regard.

H. G. Rickover

Copy to:
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts,
Naval Sea Systems Command

July 8, 1980

Current Status - Newport News Shipbuilding and Dry Dock Company

1. There are no known loss contracts for Navy work at Newport News. Last year the company made a $36 million profit on Navy contracts.

2. For the period 1975 through 1979 Newport News averaged a $49 million a year profit on Navy work and a $20 million a year loss on commercial ship work. Thus Navy work has been far more profitable than commercial work, notwithstanding the impression Newport News created during the claims era.

3. Newport News has expanded its submarine overhaul capability with the construction of a new dry dock. This is very profitable, low risk work for the shipyard.

4. With regard to new construction, Newport News continues to out perform Electric Boat on SSN 688 Class submarines -- the only class of ships being constructed by both shipyards. Newport News has been losing out to Electric Boat, however, in competition for additional SSN 688's in circumstances that strongly suggest deliberate underbidding by Electric Boat.

5. Although Newport News is probably our best yard for waterfront work, day-to-day relations with Newport News are becoming increasingly strained because of positions taken by the company in its business dealings with the Navy. Apparently the company expects the high profits that are normally associated with fixed-price type contracts but little or no risk. The Newport News pursuit of essentially guaranteed profits is reflected in the form of special terms and conditions demanded during the CVN 71 negotiations; the company's refusal to consider any limitations on the company's ability to submit large, after-the-fact claims -- a problem which is now stalemating the Fiscal Year 80 and 81 SSN procurement; and in the company's attempts to exploit contract changes on one contract as a means of repricing others.

6. The following indicates what the Navy has been up against in dealing with Newport News in recent months:

a. CVN 71 Negotiations -- Last fall the Navy proposed to settle terms and conditions quickly on CVN 71 by accepting those that had previously been negotiated with the company a year earlier in definitizing the CVN 70 contract. Ordering of long lead time material for CVN 71 was delayed about six months after funds became available as the company pursued special terms and conditions

which would give them price adjustments for changes in law, energy shortages and so on. While the Navy made many concessions to Newport News, it could not award a long lead time material contract to Newport News because of company insistence that the Navy define claim certification requirements prescribed by federal statutes, in a manner that would render them meaningless. The Secretary of the Navy eventually prevailed upon Tenneco management to drop these demands. Although the long lead time contract was finally signed in May, the Navy still does not yet have a proposal from the company for actual construction of the CVN 71.

b. SSN 688 Negotiations -- In trying to comply with the Congressional mandate to administer contracts on a pay-as-you-go basis, the Navy included in the FY 80/81 SSN solicitation terms and conditions which would establish criteria for determining when a drawing revision would involve a contract change and to require prompt notification by the shipbuilder of any Government action or inaction considered to involve a contract change. Electric Boat has agreed to this approach but is holding out for a loophole which would enable Electric Boat to submit cross-contract impact claims without regard to time limit. Newport News, on the other hand, will not agree to negotiate criteria defining which drawing revisions constitute a contract change nor will the company agree to any meaningful limit on its ability to assert large, after-the-fact claims. In this regard, the clause now proposed by the Navy provides the shipbuilder a minimum of nine months in which to notify the Navy that he intended to submit a claim. Newport News has taken a "take it or leave it" position with the Navy, refusing the Navy's proposed provisions or any changes in this area from past contracts. Newport News is now trying to enlist the support of other shipbuilders through the Shipbuilders Council of America in resisting the Navy's attempts to eliminate the loopholes that permit large, after-the-fact claims.

c. The change to Government Furnished Equipment in the ARKANSAS -- A reactor noise problem was recently discovered at Newport News in the ARKANSAS (CGN 41). While we have determined that the reactor will operate safely and reliably in its present condition, it would be better from a technical standpoint to install an improved design now, before the core becomes radioactive. Consistent with the objective of pricing out work in advance on a pay-as-you-go basis, the Navy asked Newport News for a maximum price for doing this work. The company proposed a $32 million maximum price but insisted that if the Government authorizes this job it will adversely impact other Navy contracts at the shipyard. The company, however, provides no substantiation. It appears that Newport News is trying to take advantage of this technical problem

in order to gain Government acceptance of the claim theory of cross-contract impact under which contractors could exploit a change on one contract to reprice others. Since the company will neither drop its demand for "impact" nor substantiate it, the work will not be authorized at Newport News.

7. In dealing with the Navy Newport News is taking a hard line. The company's position is essentially that Newport News is free to make proposals which the Government can either accept or reject, but that the company is under no obligation to accept the Government's terms and conditions -- particularly those that would inhibit the company's ability to submit claims at any time or that would close loopholes in terms and conditions which would provide for price reopeners.

8. There has been a tendency on the part of Navy officials to play down the problems with Electric Boat and Newport News. The Navy does not want to be accused as in the past of having bad relations with the shipbuilders. However, unless the Navy faces this problem squarely we will again be confronted several years hence with large claims of the type that recently had to be settled under P.L. 85-804. The problem at Electric Boat assumes particular significance because in all likelihood the company faces substantial cost overruns on its SSN 688 ship construction contracts.

9. Since Newport News has been unable to gain acceptance of their position within the Navy, the company may try to elicit support in Congress. If we are to avoid a repeat of past claims problems, it is imperative that future contracts provide adequate protection against large, after-the-fact claims.

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
10 December 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Proposed meeting between Navy officials and senior shipbuilding executives on December 17, 1980 concerning Navy procurement policy

Ref: (a) Assistant Secretary Doyle letter dtd 12 November 1980
(b) My Memorandum to SECNAV dtd 28 June 1978
(c) My Memorandum to SECNAV dtd 19 May 1979
(d) Notes for discussion with Secretary Hidalgo dtd 14 April 1980
(e) My Memorandum to SECNAV dtd 4 March 1980

1. Reference (a) announced that, on December 17, 1980 you and other senior Navy officials would be meeting with senior shipbuilding executives as a follow-up to a meeting you held on April 16, 1980 regarding progress the Navy was making in implementing the recommendations of the Naval Ship Procurement Process Study (NSPPS). In preparation for the December 17th meeting, copies of the recommendations of the Navy's Ship Acquisition Policy Advisory Committee (SAPAC) were forwarded to the shipbuilders by reference (a) with the explanation that the Navy positions are not immutable and that: "We are always receptive to recommendations from members of the shipbuilding community and strongly encourage you to continue to offer your thoughts." The purpose of this memorandum is to explain why it is important that during the December 17th meeting with the shipbuilders, you take a firm stand against the submission of large after-the-fact claims and in support of Navy efforts to administer contracts on a pay-as-you-go basis.

2. As you know, the large backlog of claims during the 1970's tied the Navy in knots and generated unfavorable publicity for the Navy. The backlog at one time totaled $2.7 billion in unsettled claims from Litton, General Dynamics, and Tenneco. Although the details of these claims varied, they were all large - many in excess of one hundred million dollars per contract. They were so-called omnibus claims in which the contractor alleged, years after the fact, that the Navy required large amounts of work over and above the contract requirements and therefore owed the contractor price adjustments to cover all his overruns plus his desired profit. Many of these claims, and those preceding them from shipyards such as Avondale, Todd and Lockheed, were greatly exaggerated. The Navy referred the claims from Lockheed, Litton, Newport News, and Electric Boat to the Department of Justice to investigate for possible fraud.

3. In 1978, you and Secretary of the Navy Claytor, in order to settle the shipbuilding claims, had to grant extra contractual relief totaling approximately $566 million under P.L. 85-804. However, not all problems were resolved by these claim settlements. It appears that at least some contractors came away from the experience convinced that the submission of inflated, after-the-fact claims is an effective means to recover from the Government the costs of their own mistakes and inefficiencies.

4. As I pointed out in references (b) and (c), and again during our discussions on April 14, 1980 (reference (d)), the Naval Ship Procurement Process Study, issued at the time of the P.L. 85-804 settlements, further complicated matters by addressing complaints some shipbuilders had leveled against the Navy, while ignoring the problems some of these very same shipbuilders had made for the Navy; e.g., submission of false or frivolous claims; refusing to provide prompt notification of claims; thwarting Navy efforts to ensure pay-as-you-go contracting; threatening to stop work or actually stopping work on urgent defense programs, to force settlement without regard to contract terms; frustrating settlement of contract disputes before the Armed Services Board of Contract Appeals or in Federal courts; and using inflated claims as a means to enhance the price of stock and consequently the compensation of corporate executives. However, notwithstanding its shortcomings, I understand that the Naval Ship Procurement Process Study will again be the focal point of the December 17th meeting with the shipbuilders.

5. Subsequent to the P.L. 85-804 settlement there has been no indication that the problems described in paragraph 4 above have been laid to rest or that we will in any way be better able to defend against these practices in future. While the Contract Disputes Act of 1978 provides added safeguards, such as additional requirements for contractor certification of claims and strict sanctions in the case of contractors who submit fraudulent claims, the claims lawyers who control the Public Contract Law Section of the American Bar Association have been working arduously to eliminate or at least greatly water down the safeguards intended by that Act. The fruits of their work are already evident in the implementing regulations issued by the Office of Federal Procurement Policy, and in their avowed efforts to promote legislation to eliminate the fraud sanctions from the Contract Disputes Act.

6. Within the Navy, you have approved the use, in future shipbuilding contracts, of a new Notification of Changes clause, the purpose of which is to ensure that contractors identify and submit claims promptly, rather than saving them to serve later as the basis of a large omnibus claim. In some respects, the new clause

is a relaxation from previous clauses of this type. Under this clause, the contractor is not to proceed with work that he considers constitutes a change to the contract requirements, without obtaining the prior written authorization of the contracting officer. In addition, this clause gives the contractors nine months in which to review contract performance during the previous six month period, to determine if there are any other bases for claims. Upon completion of the review period the contractor must grant the Government a claims release for any items not specifically identified as a claim. This gives the shipbuilder ample time to identify claim items, while at the same time giving the Navy protection against claims based on incidents allegedly occurring years earlier.

7. The Navy's P.L. 85-804 claim settlements and the Naval Ship Procurement Process Study have apparently whetted the appetite of some shipbuilders. They are maneuvering to ensure that, in future, they will be able to employ to their advantage large, after-the-fact claims. Although Navy work at Newport News, for example, seems to be quite profitable, company officials have taken the position that they will not accept ship construction contracts that would in any way bar them from submitting claims at any time because, they say, they might not find all valid claim items within the 9-15 month review period provided for in the Navy's Notification of Changes Clause. I understand that Newport News, through the Shipbuilding Council of America, is trying to enlist the support of other shipbuilders in opposing the Navy clause.

8. Litton's Navy contracts are primarily cost reimbursement type contracts - even for new construction of non-nuclear ships. However, as I pointed out previously in reference (e), Litton has substantially overrun even its own high cost estimates for performing the last two submarine overhauls at that yard. Although the Government is obliged by the terms of the contract to reimburse all costs the company incurs, Litton has submitted a claim for one overhaul contract and is putting together a claim on the other contract. These claims would have the Government pay additional profit on Litton cost overruns.

9. As you know, the Electric Boat situation is largely out of hand. Serious productivity and quality control problems (defective welding, installation of non-conforming steel, use of wrong paint) at the yard have resulted in large delays to the TRIDENT and SSN 688 Class ship construction programs. The Navy has been unable to get from Electric Boat any detailed submarine construction schedules. Electric Boat has informed the Navy that it intends to recover, from the Government, all costs associated with the correction of these problems under the Government insurance

provisions of their contracts. Historically, the Government has insured shipbuilders and other contractors only against damage resulting from accidents; not for the contractors' own defects in workmanship and materials. The Electric Boat interpretation of the Government insurance clause would free shipbuilders from all risks - including the results of their own poor performance. The Navy has informed Electric Boat that it does not agree that the items mentioned are compensable under the Government insurance clause. The company has been stalling the submission of its claim.

10. As a supplement to the insurance claim, which the company has not yet submitted, Electric Boat seems to be trying to set up the Navy for an omnibus claim, in the event they cannot shift the financial responsibility for their problems to the Government under their theory of Government self-insurance. As a result it has become impossible to carry out day-to-day business with Electric Boat in a businesslike manner.

11. To establish a basis for subsequent claims, Electric Boat has, in recent months, been alleging that even the most minor of work items which the Government needs to get accomplished between now and completion of the lead TRIDENT (OHIO) will delay delivery of that ship, with subsequent effect on follow ships. Because Electric Boat has refused to back off from this position, the Navy has been forced to issue unilateral changes for minor work items which the Navy knows will not delay construction. This generates the backlog of unadjudicated changes that Electric Boat so desires to accumulate in its attempt to make the Navy the scapegoat for dealys and increased costs arising from the company's own mismanagement. Meanwhile, the company actively continues to seek additional Navy contracts as part of its previously announced efforts to establish a monopoly in nuclear submarine construction.

12. As in the past, shipbuilders will no doubt use the December 17th meeting with you and other senior Navy officials to try to badger the Navy into further relaxing terms and conditions and adopting procurement policies which will shift to the Navy even greater financial responsibility for problems the shipbuilders incur. In the past Navy officials have taken a defensive posture - sympathizing with shipbuilder complaints and creating the impression that the Navy will continue to revise its procurement policies in an effort to make them more acceptable to the shipbuilder.

13. In reference (d) I recommended that, in meeting with shipbuilder representatives to discuss implementation of the Naval Ship Procurement Process Study, you make it clear to them

that:

-- The Navy intends to administer contracts on a pay-as-you-go basis.

-- Shipbuilders must confine their proposals for changes to the merits of the change.

-- The Navy will enforce statutory requirements concerning claims.

-- Shipbuilders must stop using claims as a tool in financial reporting to stockholders.

I understand that you did not address any of these points in your April 16, 1980 meeting with the shipbuilders, except your displeasure at a Comptroller General report that suggested that future claims from Electric Boat were likely.

14. I realize that you devoted a large portion of your first 2 years with the Navy in dealing with the shipbuilding claims problems. The greatest contribution you could make at this time would be to close the door firmly during the December 17th meeting on any continuing effort to "improve" Navy procurement policies along the lines being requested by the shipbuilders. As long as the Navy continues to welcome their proposals (which are all aimed in the one direction of shifting risks to the Government and facilitating the submission of claims), they will continue to submit them. The concept that terms and conditions are always at fault when contractors fail to make their desired profits needs to be laid to rest. So also should we take action to deter the claims lawyers who are thriving from the generation of contract disputes between the Navy and its shipbuilders to make contracts an unenforceable compendium of legal theories and concepts rather than a common sense agreement between buyer and seller.

15. Based on the above I recommend that during the December 17, 1980 meeting with the shipbuilders you emphasize the points I recommended you make in your previous meetings, namely:

a. The Navy intends to administer contracts on a pay-as-you-go basis. To accomplish this, shipbuilders must fully price and resolve changes as they arise, and comply with the Navy's claim notification provisions.

b. Shipbuilders must confine their proposals for changed work to the merits of the change. The Navy will pay the legitimate cost of changes, but not arbitrary and unsubstantiated factors layered on these costs. Some shipbuilders are trying to "game" the Government.

c. False and inflated claims waste thousands of hours of effort of Navy personnel. To discourage such waste, the Navy will carry out its responsibilities by strongly seeking enforcement of the applicable United States statutes governing such matters.

d. Shipbuilders must stop using inflated claims to book more favorable profit and loss figures for stockholders, those who are inclined by these figures to buy stocks,and the public. In the past, financial reporting considerations have been an impediment to settlement of claims on their merits. If this problem persists, the Navy will seek enforcement of remedies through the Securities and Exchange Commission.

e. The Navy will invoke the Defense Production Act or other statutues to preclude disruption of urgent defense projects by contractors who stop work in order to gain leverage in contract disputes.

16. I request that I be informed prior to the December 17th meeting whether you agree or disagree with my recommendations and whether you will take the recommended actions at that meeting.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Manpower, Reserve Affairs and Logistics)
The General Counsel of the Navy
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts
Naval Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

7 January 1981

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Notification of Changes clause for the FY 80/81 TRIDENT shipbuilding contract

Ref: (a) COMNAVSEA Memorandum dated 6 January 1981

1. In reference (a) the Commander, Naval Sea Systems Command points out that Navy acceptance of the Electric Boat version of the Notification of Changes clause in the TRIDENT contract, as the Secretary of the Navy has apparently directed, will no doubt be interpreted by shipbuilders, including Electric Boat, as a precedent for subsequent procurements. He noted the Electric Boat version of the clause leaves the Navy vulnerable to future cross contract impact claims. Reference (a) further stated: "If the Navy is to live up to its commitments to Congress to keep contract pricing current and avoid after-the-fact claims, it is essential that the Navy be released after a reasonable period from all claims other than those for which notification has been provided."

2. During our telephone discussion last evening you said that you had raised these concerns with Assistant Secretary of the Navy Doyle and that he and the Secretary considered this was the best the Navy could obtain from Electric Boat. Apparently Secretary Doyle was also under the impression that the Navy would be able to get the Electric Boat version of this clause in the next SSN 688 Class contract and that once this happened he considered the Navy would be protected against cross contract impact claims between the TRIDENT and SSN 688 Class programs.

3. It is not correct that including the Electric Boat version of the clause in a new SSN 688 Class contract in addition to the new TRIDENT contract provides complete protection from cross contract impact claims. Even if Electric Boat accepts the clause in a new SSN 688 Class contract, the Navy will not have protection from cross contract impact claims between the new TRIDENT contract and previous SSN 688 Class contracts. Similarly the Navy will not have protection from cross contract impact claims between a new SSN 688 Class contract and previous TRIDENT contracts.

4. The Electric Boat version of the Notification of Changes clause appears to provide far more protection to the Government than it in fact provides. The language of the claims release is complex and sounds all-inclusive. Yet Electric Boat's inclusion of the words "under this contract" in the clause and in the claims release

creates a loophole the company can exploit at any time – notwithstanding the claims releases the company may have given – simply by asserting claims for items that did not arise "under this contract".

5. NAVSEA has devoted considerable effort to trying to set up procedures which would enable it to carry out its commitment to Congress to administer contracts on a pay-as-you-go basis and to avoid large after-the-fact claims. It is inconceivable that a company such as Electric Boat, which takes credit for having expert management, cannot within the nine to fifteen month period provided for by the clause identify any problems which it considers are the basis for legitimate claims. Electric Boat's insistence on the loophole preserves their flexibility to submit large claims years after the fact as they have done in the past.

6. In view of the importance of this issue I believe it warrants being raised to the highest levels of General Dynamics management with the Navy Secretariat insisting on elimination of the Electric Boat loophole. I do not believe the General Manager of Electric Boat should be allowed to dictate to the Navy the terms under which the Navy will contract. If the Chairman of the Board remains adamant, then I recommend that the Navy hold up award of the TRIDENT contract and promptly inform the appropriate Congressional committees that, without cooperation from General Dynamics or statutory requirements, the Navy will not be able to provide the Congress any assurance that it has taken adequate steps to protect against large after-the-fact claims.

7. I would appreciate being advised of the action you take in response to this memorandum.

H. G. Rickover

Copy to:
Secretary of the Navy
Assistant Secretary of the Navy
(Manpower, Reserve Affairs & Logistics)
General Counsel of the Navy
Commander, Naval Sea Systems Command
Deputy Commander for Contracts, Naval
Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
Ser 00/0050
14 Jan 1981

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR PROPULSION
NAVAL SEA SYSTEMS COMMAND

Subj: Notification of Changes Clause for the FY 80/81 TRIDENT shipbuilding contract

Ref: (a) Your memorandum dated 7 January 1981

1. In reference (a) you informed me of various factors relevant to the "Notification of change clause for the FY 80/81 TRIDENT shipbuilding contract" and requested that I advise you of any action taken in response to that memorandum.

2. I agree that the Electric Boat version of the clause in a new SSN 688 class contract in addition to the new TRIDENT contract will not provide complete protection from cross contract impact claims. Nevertheless, as you point out, it does protect the government under the new TRIDENT contract. I do not believe that it would be to our advantage to reopen the old TRIDENT and 688 contracts to gain similar rights under them, and in view of Electric Boat unwillingness to agree to the wording we prefer in spite of persuasion to do so from NAVSEA and the Secretary, I intend no further action. As I said to you on 7 January, I believe Captain Platt has done a good job in contract neogtiation.

A. J. WHITTLE, JR.
Chief of Naval Material

Copy to:
CNO
COMNAVSEA

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

25 July 1981

The Honorable John C. Danforth
Chairman, Subcommittee on Federal
Expenditures, Research and Rules
Committee on Governmental Affairs
United States Senate
Washington, D. C. 20510

Dear Senator Danforth:

This is in response to your letter dated July 10, 1981 in which you asked for my comments on H.R. 1371, a proposed amendment to the Contract Disputes Act regarding the determination of interest rates in calculating interest payable to contractors on successful claims against the Government. You also asked for my views on the interpretation of the Act that appears on page 3 of the House Judiciary Committee report on H.R. 1371.

I have no objection to H.R. 1371 in the form in which it passed the House and was referred to your Committee. The bill would amend the Contract Disputes Act to delete reference to the Renegotiation Board in connection with the determination of interest rates applicable to contract claims, since that Board is now defunct. The method proposed in H.R. 1371 for the calculation of interest is satisfactory.

I believe, however, that the language inserted in the House Judiciary Committee report contains incorrect interpretations of the Act that, if allowed to stand, may be used by contractors and claims lawyers to the substantial detriment of the U. S. taxpayers. Specifically, page 3 of the Committee report states:

* * * * *

"Incident to its consideration of this bill, the committee was advised that there is some question concerning the time that interest begins to run despite the fact that section 12 clearly states that 'Interest on amounts due contractors on claims shall be paid to the contractor from the date the contracting officer receives the claim pursuant to section 6(a)***.'

"When Congress enacted the Contract Disputes Act of 1978, it was understood that submission of a claim in writing to a contracting officer under section 6(a) was the starting point for interest to begin to run on a contract claim. The separate provisions of section 6(c) requiring the

92-782 O - 82 - 27

'certification' of a claim and its supporting data when the claim is in excess of $50,000 was intended as a condition precedent to payment, but was not a delayed starting point for the interest accruing period. Certain agencies have argued that they have not 'received' a claim under the Act until the necessary certification data has been submitted. This is not the correct interpretation. In fact, it often leads to an unfair result in that a contractor does not have all the necessary supportive data available to satisfy certification procedures, when he initially notifies the agency in writing of a contract claim. It is likewise impossible for the contractor, at this stage of the proceeding, to anticipate what supplemental data might be requested by the contracting officer in the course of consideration of the claim. Certification under section 6(c) should not be viewed as a prerequisite to 'receipt' of a claim under section 6(a)."

* * * * *

This language, if endorsed by the Congress, would effectively undermine the claim certification provisions of the Contract Disputes Act. It plays into the hands of claims lawyers and their clients who have been trying to accrue interest from the time they first notify the Government of a claim but to delay certification of the claim, perhaps indefinitely.

To put the issue in perspective it is useful to recall how the Contract Disputes Act came to be. The Public Contract Law Section of the American Bar Association (ABA) drafted a disputes bill and lobbied extensively for its passage after it was introduced. That bill contained various loopholes which, for the first time, would have enabled Government agencies to settle claims independent of their merits and without Congressional review. Overall, the bill drafted by the ABA would have given claims lawyers and their clients a substantial advantage over the Government in contract disputes.

On June 14, 1978 I testified before a joint session of the Senate Judiciary Committee and the Senate Governmental Affairs Committee concerning the proposed Contract Disputes legislation. I pointed out many of the loopholes in the ABA-favored bill and recommended a number of additions be made to the bill, including a requirement for certification of claims.

Congress subsequently deleted some of these loopholes and inserted additional provisions to discourage the submission of frivolous or inflated claims. The requirement that contractors certify claims over $50,000 is one of these provisions. Claims lawyers have subsequently sought to undermine this requirement.

The recommendation for a claim certification requirement grew out of the practice of some contractors and claims lawyers who harass the Government with inflated and frivolous claims in an attempt to "horse trade" a settlement for some fraction of the claimed amount without regard to the merits of the claim. The problem with this practice is that the Government is obliged to review the contractor's entire claim regardless of the merits of his allegations or the amounts claimed. In Naval shipbuilding, omnibus claims have been submitted covering events which occurred during a period of six to eight years earlier. Typically, the work involved in properly evaluating contract claims requires substantial time and effort on the part of those who have primary responsibility for ongoing programs.

The claim certification requirement recognizes that submitting a contract claim against the United States Government for increased compensation or some other form of benefit should be a serious matter. Government resources should not be wasted in evaluating claims that a contractor is not himself willing to stand behind as evidenced by his certification.

For purposes of calculating interest payments, claims lawyers and their clients are seeking to have their claims considered "claims" at the earliest date. To preserve their ability to try to bargain for high settlements with inflated and frivolous claims, however, they want to put off, or if possible avoid altogether, claim certification. For purposes of complying with statutory requirements for claims certification, therefore, they do not wish to have their claims considered "claims" until as late as possible – preferably after all efforts to settle the claim short of referring it to a Board of Contract Appeals have been exhausted.

The language contained in the House Judiciary Committee report, if allowed to stand unchallenged,will no doubt be used by claims lawyers as "legislative intent" to have such a double standard. This would largely nullify the value of claims certification as a deterrent of inflated or frivolous claims.

The Committee report language goes beyond the Contract Disputes Act and introduces new concepts not included in the statute. The report is written as if the starting point for determining interest on a claim is the time a contractor first "notifies" the Government of a claim, not the time of claim submission as set forth in the Act. In my experience, "notification" of a claim and actual claim submission tend to be separate events. For example, in 1974 Newport News Shipbuilding notified the Government of its intent to submit claims under various shipbuilding contracts. However, the bulk of these claims were not submitted until 1975 and 1976. General Dynamics' Electric Boat Division, about a year ago, began

asserting its intention to submit a so-called "insurance" claim against the Government to cover the cost of the contractor's own defective material and workmanship. Recently Electric Boat finally submitted one such claim for one ship and indicated that other claims will be forthcoming. In the case of contract claims that merit entitlement, the Committee report language could make the Government liable for interest accrued prior to the Government having available the claim for review.

The language of the House Judiciary Committee report similarly would permit contractors to submit an incomplete claim and withhold certification until supplemental data requested by the Government is provided. Presumably after the Government has performed a detailed audit of the claim, pointed out areas where the contractor's case is weak or incomplete, and made specific requests for additional information, the contractor would be finally required to certify the claim. But to require certification after receiving and reviewing a claim makes little sense, and is contrary to the clear intent of the certification requirement to preclude inflated or frivolous claims.

The standards for claims submissions of Government contractors, who tend to be large corporations, should be no less than the standards required of individual taxpayers in filing their income tax returns. Taxpayers cannot wait until the Internal Revenue Service audits their tax return and receives additional supporting data requested to support the tax return prior to signing and certifying the return. Why should uncertified, incomplete contract claims be tolerated?

I strongly recommend that your Committee clarify the statute, as a result of the language inserted in the House Judiciary Committee report, and specify that a claim is not considered to be a claim for purposes of accruing interest until such time as a fully documented and certified claim has been submitted in writing to the Government for its evaluation. If the language in the House Judiciary Committee report is not reversed, Government agencies will continue to be vulnerable to false and inflated claims and higher than necessary costs to the taxpayer. Moreover, contractors will be encouraged by that language to constantly put the Government on notice of claims to be asserted – whether or not there is a valid basis for the claims – simply to achieve an early date from which to calculate interest if a claim is later asserted.

If you or the Committee staff have further questions, I would be glad to try to answer them.

Respectfully,

H. G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
26 August 1981

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Claims release for TRIDENT contracts

1. Thank you for sending me a copy of the proposed language negotiated between NAVSEA and Electric Boat representatives for the TRIDENT claims release. The proposed release still suffers from the deficiency I mentioned in my telephone call to you this morning.

2. Under the proposed release, the Navy would allow Electric Boat to reserve the right to submit, except for the welding, steel, and paint problems, insurance claims for prior instances of their own defective material and workmanship. In his recent address to the Press Club, however, Secretary Lehman stated with regard to such claims by Electric Boat:

> " ... Electric Boat has recently injected a new and very disruptive element into our business relations. They have submitted a multi-million dollar claim to compensate them for rework costs caused by their own faulty performance on certain of the 688 submarines. This, in my judgment, was an ill-advised move by the General Dynamics management, and I hope that they will reconsider and withdraw that claim. For a corporation to pursue, as a policy, the principle that the taxpayers should pay for the mistakes, the negligence, the poor workmanship, or the inadequate management of that company in carrying out a contract with the Government, is preposterous."

3. Under the circumstances it seems to me that in wiping the slate clean for potential claim items to date on the TRIDENT contract, it would be inappropriate for the Navy to enter into an agreement that would exempt from the claims release insurance claims covering Electric Boat's own defective material and workmanship.

4. There is no reason why Electric Boat could not agree to release these items now. General Dynamics officials have been contending that their TRIDENT problems are behind them.

5. For the above reasons, I strongly recommend that the Navy inform Electric Boat negotiators that the Navy will not exempt insurance claims from the proposed TRIDENT claims release.

H. G. Rickover

Copy to:
Counsel, Naval Sea Systems Command
Deputy Commander for Contracts, Naval Sea Systems Command
Deputy Commander for Submarines, Naval Sea Systems Command
Project Manager, TRIDENT Submarine Ship Acquisition Project

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

13 January 1982

The Honorable William French Smith
Attorney General
Washington, D.C. 20530

Dear Mr. Attorney General:

Over the past decade I have documented and reported to Defense Department officials numerous examples of false claims submitted by three major shipbuilders, Litton, General Dynamics, and Tenneco. The Navy, after reviewing these reports, forwarded them for investigation by the Justice Department. Today, after years of effort, it appears that the Justice Department is systematically closing down these investigations - either overtly or by inaction - even though the claims are demonstrably false and those who have investigated them have, I believe, recommended to their superiors that indictments be sought. In view of the Justice Department's poor record in this area, and its impact on Government procurement, I am bringing this matter to your attention with my recommendations for corrective action.

Here is the status of the four major shipbuilding claim investigations, as I understand it:

- Litton. The Navy spent about 18 months investigating the possibility of fraud in connection with an approximately $40 million claim on a Navy submarine contract; the Justice Department spent another two and one half years investigating it. In April, 1977 Litton Systems, Inc. was indicted for fraud in the Federal District Court for the Eastern District of Virginia. In 1978, Litton won a change of venue to the Federal District Court in Mississippi, where this case has lain dormant ever since. To my knowledge, in the intervening years the Justice Department has made no effort to bring this case to trial. With the passage of time, the likelihood of prosecution becomes more remote - the two attorneys who handled the Government's case are now in private practice.

- General Dynamics. On December 10, 1977 I reported specific examples of apparent fraud in connection with General Dynamics' claims under Navy shipbuilding contracts at Electric Boat. Subsequent Navy evaluation of the claims revealed that more than three fourths of the $544 million claimed by General Dynamics was not valid. Yet after almost four years of investigation by the Justice Department, I was notified on November 11, 1981 by the departing head of the Justice Department's Criminal Fraud Section that the Justice Department was dropping

the General Dynamics case, having concluded there was not sufficient evidence to prove criminal intent. On January 5, 1982 the Justice Department issued a press release to this effect.

• Tenneco. During 1977 and 1978 I submitted several reports of apparent fraud in connection with Tenneco claims on Navy shipbuilding contracts at Newport News. A special fraud section in the office of the U.S. Attorney for the Eastern District of Virginia undertook the investigation and, I understand, recently sent the Justice Department a report strongly recommending prosecution and requesting a few paralegals to help conclude the investigation. On November 13, 1981 — but two days after the head of the Justice Department's Criminal Fraud Section told me she was dropping the General Dynamics investigation, I discovered that the person appointed for the position of U.S. Attorney for the Eastern District of Virginia had announced that she would abolish the special fraud section handling the Newport News case upon taking office. I understand that she has now done so, and that the two senior attorneys who had been handling this case have been reassigned other responsibilities — one as head of the civil litigation section and the other as head of the criminal section within the U.S. Attorney's office. Although the Newport News investigation has not been dropped officially, I can think of no better way to scuttle a complex investigation of this sort than to abolish the unit handling the investigation, split up the investigation team, and impose additional responsibilities upon those familiar with the case.

• Lockheed. In addition to the above three cases with which I am familiar, the Navy in December 1974 referred to the Justice Department a $158 million claim relating to construction of several non-nuclear powered destroyers and amphibious ships. I am unaware of the details except that the Navy concluded that only about $7 million of the claim was valid, and found indications of fraud. I understand that after four years of investigation the Department of Justice declined to seek an indictment.

The claims to which I refer were inflated by hundreds of millions of dollars. They were the work of professionals — high priced lawyers and financial experts who seem to have structured these claims with one eye on the fraud statutes. The claims preparation effort was fragmented within these large corporations, so that finding individuals to hold accountable is far more difficult than proving the claim is false.

Some senior shipbuilding officials have pressured senior defense officials into paying them hundreds of millions of dollars more than they were actually owed knowing that senior Government executives, legislators, the media, and even the courts, cannot deal effectively with massive claims. Later, these shipbuilding

officials can disclaim knowledge of the details of the claims which were prepared by others.

In investigating these claims, the Justice Department has tended to focus its efforts on finding the so-called "smoking gun" — forged or altered documents, fraudulent invoices, and the like. While such evidence makes conviction easier, today's sophisticated claims lawyers rarely leave incriminating evidence of this sort. However, this should not excuse the crime.

In conducting investigations and prosecuting these claims, Justice Department officials need to look beyond textbook examples to identify the essence of the fraudulent practice. American Jurisprudence states the following with respect to fraud:

> " ... it has been said that there can be no all-embracing definition of 'fraud' but each case must be considered upon its own peculiar facts. The term 'fraud' is a generic one which is used in various senses, and fraud assumes so many different degrees and forms that courts are compelled to content themselves with comparatively few general rules for its discovery and defeat, and allow the facts and circumstances peculiar to each case to bear heavily on the conscience and judgment of the court or jury in determining its presence or absence. In fact, the fertility of man's invention in devising new schemes of fraud is so great that courts have always declined to define it, reserving to themselves the liberty to deal with it in whatever form it may present itself. It is, indeed, said that it is better not to define the term lest the craft of men should find ways of committing fraud which might evade such a definition."

With this criteria a judge and jury, if given a chance, should be able to see through the shipbuilder claim schemes and convict corporate officials or others responsible.

The Justice Department's inability or unwillingness to prosecute these claims in effect tells Government contractors that, notwithstanding the obvious thrust of the various federal fraud and false claim statutes, it is proper for contractors to make false and inflated claims against the Government.

Reporting apparent fraud or other misconduct as required by Defense Department directives requires substantial effort far above and beyond our normal tasks. However, there seems to be no serious commitment within Government to take on hard cases, no matter how important. My reports were not welcomed by senior Navy officials. Having been confronted with the facts, however, they had no alternative but to refer the problems to the Department of Justice.

The Justice Department, with its limited resources, did not appear eager to investigate these large, complex cases. Moreover, the investigations typically were hampered by lack of high level interest and continuity of personnel. Justice Department attorneys and agents assigned to investigate shipbuilding claims were frequently pulled off these cases to work on others.

We must find a way to deter those who would take advantage of the Government from adopting those claims practices which have proved over the years to be so lucrative for some Navy shipbuilders. Present statutes would seem to offer adequate bases to prosecute those who submit false claims. What is needed is a genuine commitment by the Department of Justice to enforce these statutes against large corporations.

With respect to the present cases, I recommend that the Justice Department:

1. Provide the necessary resources and priority to bring the Litton case to trial and prosecute it effectively. A conviction in this case would help dispel the widespread notion that making false claims against the Government is an acceptable practice, entailing little or no risk.

2. Establish a review board made up of experienced prosecutors not previously involved with the General Dynamics case to review in depth the decision not to prosecute that corporation. Particular emphasis should be placed on the extent to which General Dynamics representatives, in their meetings with senior Department officials or others, may have brought undue pressure to bear.

3. Keep intact at the U.S. Attorney's office in the Eastern District of Virginia the special fraud team that has been investigating the Newport News claim and avoid weighing them down with other functions that will dilute this effort. Provide the additional administrative resources they need to see the investigation through to completion.

4. From experience drawn from the investigations to date, determine what additional legislation, if any, is needed to deter contractors from submitting false and inflated claims.

The lack of Justice Department action with existing false claims serves to encourage even more such claims and undermines the Administration's stated objectives of reducing unnecessary Government expenditures and instituting an expanded Navy shipbuilding program. It is of vital importance that the Justice Department assign the necessary resources and high priority to implementing the above recommendations.

I would appreciate being informed prior to the end of this month of the action you intend to take with respect to these matters.

Respectfully,

H. G. Rickover

Copy to:
Secretary of Defense
Secretary of the Navy
Chief of Naval Operations
U.S. Attorney for the Eastern
District of Virginia
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command
Counsel, Naval Sea Systems Command
Deputy Commander for Contracts, Naval
Sea Systems Command
Chief, Criminal Fraud Section,
Department of Justice

WILLIAM PROXMIRE
WISCONSIN

United States Senate

WASHINGTON, D.C. 20510

February 24, 1982

The Honorable William French Smith
Attorney General
The Department of Justice
Washington, D.C. 20530

Dear Mr. Attorney General:

Prior to his retirement, Admiral H. G. Rickover provided the Joint Economic Committee with a copy of his January 13, 1982 letter to you concerning shipbuilding claims against the Navy.

As Admiral Rickover explained, the Justice Department has been systematically closing down investigations of alledged false claims by Navy shipbuilders. These cases were all referred to the Justice Department by the Navy after thorough Navy investigations disclosed significant evidence that criminal laws may have been violated. The cases, involving Litton, General Dynamics, Tenneco, and Lockheed, were in turn investigated by the Justice Department. Yet, after years of investigations, and an indictment against Litton, the cases have languished and are now being dropped.

I request that you provide me with a status report of each of these cases together with an explanation of why they have dragged on for so long and why they are being dropped. For each case, I would like to know the names of each of the attorneys assigned principal responsibilities together with the present addresses of those no longer with the Justice Department.

I would also like to have a copy of your response to Admiral Rickover's January 13 letter.

Your cooperation will be greatly appreciated.

Sincerely,

William Proxmire

U.S. Department of Justice

Criminal Division

1982 MAR 11 PM 3:43

Assistant Attorney General

Washington, D.C. 20530

Honorable William Proxmire
United States Senate
Washington, D. C. 20510

Dear Senator Proxmire:

Your letter of February 24, 1982, to the Attorney General concerning various shipbuilding claims against the Navy has been referred to the Criminal Division for reply.

In accord with your request, I have enclosed a copy of my letter to the Naval Sea Systems Command. I believe the letter adequately summarizes the status of each of the four (4) investigations or cases identified in your letter. Two matters have been declined (General Dynamics in 1981 and Lockheed in 1979); one matter continues to be the subject of investigation and close review (Newport News); and the third is under indictment. The staffing of the Litton case for trial is presently under review, and I can assure you the Justice Department is committed to providing sufficient manpower and expertise to bring the case to a fair and just conclusion.

Our letter to Naval Sea Systems Command generally refers to the difficulties incurred in developing the shipbuilding investigations. As you know, the Criminal Division attorneys, together with the United States Attorney's office in the Eastern District of Virginia, staffed each of the four investigations. While I must respectfully decline to provide the names of the attorneys assigned for Department policy reasons, I am prepared to answer any specific questions you may have on the reasons for our declination of the two closed investigations.

I appreciate your interest in our work and assure you these matters have been accorded the highest priority.

Sincerely,

D. Lowell Jensen
Assistant Attorney General
Criminal Division

Enclosure

Vice Admiral K. R. McKee
Naval Sea Systems Command
Department of the Navy
Washington, DC 20362

Dear Admiral McKee:

I am pleased to respond to Admiral Rickover's letter of January 13, 1982, to the Attorney General, recounting his views and experiences with the Navy shipbuilding equitable claims and the investigations of Lockheed, Litton, General Dynamics and Tenneco. In that letter, he requested we advise him of the action we intend to take with respect to such matters, and he made certain recommendations. Please let me advise you first on the status of them, which, with the exception of the Lockheed matter, we, on January 5, 1982, advised Mr. Joseph Sherrick, Assistant to the Secretary of Defense for Review and Oversight.

General Dynamics ("Electric Boat"). After a lengthy and complex investigation, the Justice Department advised Secretary of Navy John Lehman on December 18, 1981, that we had declined prosecution. We then advised counsel for Electric Boat that we had declined prosecution and, at their request, issued a press release of our decision. As a result of our decision, we have closed our files in this matter.

Litton and Newport News. Representatives of the Criminal Division met earlier this month with Elsie Munsell, the United States Attorney for the Eastern District of Virginia, and her staff to discuss the status of the Litton prosecution and the Newport News ("Tenneco") investigation, two separate and distinct matters. Admiral Rickover was correct in his observations that Litton was indicted by a Federal grand jury sitting in Alexandria, Virginia, in 1977 and that the case was removed to the Southern District of Mississippi for trial in 1979. I assure you that the Justice Department is committed to providing sufficient manpower and expertise to protect the government's interests and, at the same time, to move the Litton case expeditiously to a fair and just conclusion. The Tenneco investigation has not been completed and, as a result, we are unable to disclose further the status on this matter. However, the Justice Department is committed to making the same resources of manpower and expertise as in Litton.

Lockheed. Our records were closed in this matter in 1979, and we have received no evidence that it should be reopened.

The Criminal Division's attention to the serious problems inherent in the government claims process were raised most dramatically in connection with the four investigations discussed in Admiral Rickover's letter. There are certain practices and procedures on the part of both the contractors and the government which make developing a successful investigation and prosecution difficult. Recently, we suggested to the General Counsel of the Navy a joint effort in identifying those issues to determine if corrective measures are possible. The issues are complex and may involve a variety of competing interests outside the realm of criminal prosecution and investigation. For that reason, that review should include not only lawyers from the Navy General Counsel's office but also experts in the contract and claims process from elsewhere in the Department of the Navy. We have initiated contact with the Navy to explore these areas of interest and need and shall give serious consideration to the four recommendations on page four of Admiral Rickover's letter.

I appreciate the interest of the Navy in our work and assure you these matters have our highest priority.

Sincerely,

D. Lowell Jensen
Assistant Attorney General
Criminal Division

○