



DEFENSE CONTRACT MANAGEMENT AGENCY
OFFICE OF THE DEFENSE CORPORATE EXECUTIVE
NORTHROP GRUMMAN CORPORATION
1840 Century Park East
Los Angeles, California 90067-2199

Donald P. Springer
Defense Corporate Executive

IN REPLY
REFER TO:

DCMA-OCB

September 28, 2005

MEMORANDUM FOR ALL SECTOR ADMINISTRATIVE CONTRACTING OFFICERS (ACOs)

SUBJECT: Hurricane Guidance

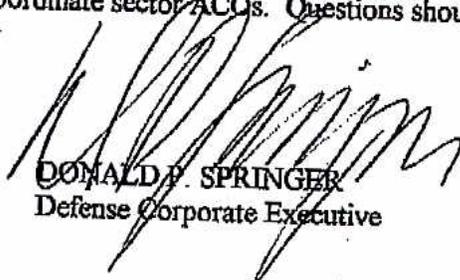
Until all avenues for recovery from insurance carriers are exhausted by the contractor it is recommended that Contracting Officers not approve payments for costs associated with or related to the hurricane disaster(s) if such costs are potentially recoverable through insurance by the contractor.

This office believes that it would be inappropriate to allow Northrop Grumman to bill for costs potentially recoverable by insurance because payment by the Government may otherwise relieve the carrier from their policy obligation.

If the Government pays the costs, or agrees that the costs are even tentatively or conditionally allowable, there is a risk that insurers will deny coverage on the basis that there has been no loss suffered by Northrop Grumman. It is my recommendation that insurance policy(s) be reviewed. Additionally, it would be prudent to reach an agreement with Northrop and the insurer, before making payments for any otherwise allowable costs.

This matter is under continuing review and additional information will be forwarded as appropriate.

Please forward this correspondence to subordinate sector ACOs. Questions should be addressed to me.


DONALD P. SPRINGER
Defense Corporate Executive

cc: Teri Ryan
Scott Gentry



DEFENSE CONTRACT MANAGEMENT AGENCY
OFFICE OF THE DEFENSE CORPORATE EXECUTIVE
NORTHROP GRUMMAN CORPORATION
1840 Century Park East
Los Angeles, California 90067-2199

Donald P. Springer
Defense Corporate Executive

IN
REPLY
REFER
TO:

DCMA-OCB

April 12, 2006

SUBJECT: Proposed Advance Agreement Related to Certain Costs Incurred As a Result of Hurricane Katrina

Pursuant to your request, I have reviewed the proposed "Advance Agreement Related to Certain Costs Incurred As a Result of Hurricane Katrina" between Northrop Grumman Ship Systems and the United States Navy. As discussed below, I am concerned about the potential impact payments made by the Government could have upon future insurance recoveries. I believe that if the Government pays the costs or agrees that the costs are even tentatively or conditionally allowable, there is a risk of insurance companies denying coverage on the basis that there has been no loss suffered by Northrop. Accordingly, I do not believe that the Advance Agreement is advisable.

Background

Northrop Grumman Corp. ("Northrop") and its subsidiaries and divisions are insured at the primary level by a consortium of insurers for \$500M. Northrop has insurance at the excess level in the form of an "all risk" policy providing \$19 billion in coverage. The excess policy covers, among other things, property damage, debris removal, demolition and decontamination costs and business interruption. Northrop expects its Hurricane Katrina-related costs to exceed \$500M, and thus has made claims under both the primary and excess policies. The primary insurers have paid or are paying Northrop's losses. However, the excess insurer, Factory Mutual Ins. Co. ("Factory"), denied coverage based upon a flood exclusion. As a result, Northrop sued Factory in Los Angeles Superior Court on November 4, 2005, seeking coverage for its hurricane-related losses. Factory removed the case to federal court on December 6, 2005. The coverage lawsuit is currently pending in the Central District of California, styled Northrop Grumman Corp. v. Factory Mutual Ins. Co., Case No. 2:05-DC-08444-DDP-PLA.

Discussion

On October 11, 2005, the Office of the Under Secretary of Defense, Acquisition Technology and Logistics, issued a Memorandum regarding Hurricane Katrina-related costs. The memorandum cautions contracting officers evaluating Hurricane Katrina-related advance agreements "to ensure that the Government does not approve payments for contractor costs associated with Hurricane Katrina until all avenues for recovery from insurance carriers have been exhausted, if such costs are potentially recoverable through insurance by the contractor," explaining that "if the Government pays the costs, or agrees that the costs are even conditionally allowable, there is a risk that insurers will deny coverage on the basis that there has been no loss suffered by the contractor."

On October 28, 2005, DCAA issued Audit Guidance on the allowability of certain Hurricane Katrina-related costs. The Audit Guidance instructs that forward pricing proposals covering Hurricane Katrina-related costs should be reviewed in conjunction with the contractor's insurance policies as well as the contractor's explanation regarding why such costs are not covered. DCAA further explains that "[i]f it is determined that the contractor has included costs that are covered by its insurance policies, question the costs in accordance with FAR 31.205-19, Insurance costs. FAR 31.205-19 (d)(3) makes actual losses expressly unallowable if those losses are covered by insurance."

I share the concerns articulated in the above memorandums. If the Government pays the costs, Northrop's insurers may attempt to invoke the so-called "legal loss" doctrine to limit their liability for Northrop's property damage and business interruption losses. Northrop's insurers may take the position that they do not have to pay the losses because Northrop has already been made whole by the Government's payment. Whether or not the carriers ultimately prevail on this defense will depend upon the specific insurance policy provisions at issue and what state law applies, insofar as there is a split of authority regarding whether recovery from non-insurers prevents insurance recovery for the same loss. Under the majority rule on loss, an insured's recovery from a third person does not affect the insurer's responsibility to pay the loss. By contrast, under the minority rule on "legal loss," courts have limited an insurer's liability where the insured recovered on the loss from another source.

As set forth in the proposed advance agreement, Northrop's excess insurance carrier has already denied coverage, and Northrop has been forced to file a lawsuit against the insurance company. If the Navy reimburses Northrop for some of the hurricane related costs, the insurance company might attempt to use such payment as an additional defense against any claim submitted by Northrop. Thus, the Government's payment of the costs could give the insurers a potential additional defense to coverage. While it is unclear whether the insurers would prevail on any such defense, the Government's payment of such costs could, at the very least, further delay Northrop's insurance recoveries for the hurricane damage.

Moreover, I note that while the proposed Advance Agreement addresses first party losses, it is possible that Northrop may in the future be sued by third parties claiming that they suffered bodily injury or property damage as a result of hazardous materials released from Northrop

facilities during the hurricane. If the Government reimburses such third party defense and indemnity costs, there is also a risk of insurance companies denying coverage based upon the so-called "government contractor defense." Northrop's insurers may claim that liability coverage under their policies is not triggered because the Government, rather than the contractor, is liable for the damages, and under the terms of the insurance policies, the insurers only agreed to pay damages that the insured is "legally obligated to pay." While this defense would be available to the insurers irrespective of Government payment, the insurers' argument could be potentially strengthened by payment by the Government, since the insurers could then argue that such payment is evidence of or an admission of Government liability.

I have one specific comment regarding a provision of the proposed agreement. In paragraph (B)(iv) on page 4, the agreement provides that certain costs, including workforce related expenditures like paid administrative leave, are allowable under FAR 31.201-2, if reasonable. I do not believe that such costs are necessarily allowable. As set forth in FAR 31.205-6, compensation generally must be for work performed by the employee in the current year, and must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice.

The October 2005 OSD Guidance discussed these types of costs:

"We have received a number of inquiries from defense contractors regarding the cost allowability of paid administrative leave which they have granted to their employees who were unable to report for work due to Hurricane Katrina closures. Such paid absences are a fringe benefit, and their allowability should be evaluated on a case-by-case basis in accordance with Federal Acquisition Regulation (FAR) 31.205-6, 'Compensation for Personal Services.' The key issue is whether or not the specific circumstances in each case warranted the payment of administrative leave. Factors to be considered in determining the reasonableness of making such payments include whether other businesses and organizations in the same geographical area were closed as a result of Hurricane Katrina. In particular, the fact that Federal employees in the same area were granted paid administrative leave by their local management due to a Hurricane Katrina evacuation order and/or closure would generally support a finding that it was reasonable for a contractor to similarly incur administrative leave costs for its employees."

To the extent that the Navy decides to enter into an Advance Agreement, prior to any provisional payment being made, the Government and Northrop should try to obtain a written agreement from the insurance company stating that any such payment would not be used as the basis for a refusal by the insurance company to pay. However, I note that the fact that Northrop and its insurer are already in litigation could make it more difficult to obtain such an agreement.

DONALD P. SPRINGER
Defense Corporate Executive