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*Office of Inspector General*  
***Audit Report***

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*Status Update*  
*Massachusetts Heavy Industries, Inc.*  
*Title XI Loan Guarantee*

***MARITIME ADMINISTRATION***

*Report Number: MA-1999-127*  
*Date Issued: September 15, 1999*





U.S. Department of  
Transportation  
Office of the Secretary  
of Transportation  
Office of Inspector General

# Memorandum

Subject: ACTION: Status Update on Massachusetts  
Heavy Industries, Inc. Title XI Loan Guarantee  
MA-1999-127

Date: September 15, 1999

From: Alexis M. Stefani   
Assistant Inspector General for Auditing

Reply to  
Attn of: JA-40

To: Clyde J. Hart, Jr.  
Maritime Administrator

This report presents our observations on the status of the Maritime Administration's (MARAD) Title XI loan guarantee for Massachusetts Heavy Industries, Inc. (MHI). On November 1, 1996, MHI received approval from MARAD for a loan guarantee of \$55 million to reactivate and modernize the shipyard in Quincy, Massachusetts.

On July 20, 1999, we reported<sup>1</sup> that the risk of default on the guaranteed loan had materially increased due to MHI's (1) missed June 1, 1999 "interest only" payment of \$1.55 million, (2) request for a 6-month extension to make this payment, and (3) lack of a shipbuilding project to provide MHI revenue. We recommended that MARAD: (1) reassess the risk factor rating for MHI's loan guarantee as prescribed by Office of Management and Budget Circular Number A-11, and make required adjustments to its permanent indefinite budget authority, (2) ensure it had all of the information required by the Title XI program to protect the interests of the United States from default prior to making a decision on MHI's request to defer its June 1, 1999 payment, and (3) ensure that MHI provides complete and current information as required by the Title XI program prior to making a decision on the loan guarantee application by Intermare, a shipowner, for a proposed shipbuilding project at MHI.

<sup>1</sup> Office of Inspector General Report Number MA-1999-115.

On August 6, 1999, MARAD provided a written response concurring with our conclusion that the risk of default by MHI had increased materially. MARAD also concurred with our recommendations but suggested deferring the risk reassessment until December 1999.

We prepared this report because significant events warrant additional actions by MARAD. MARAD's Deputy Administrator and Title XI program staff reviewed a draft of this report and concurred with the recommendations. We conducted our work in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States.

### **Results in Brief**

Since the issuance of our last report, additional significant events have occurred. Specifically:

- On August 1, 1999, MHI missed a payment of \$258,880 to the city of Quincy, Massachusetts. This amount represents a periodic payment on a \$7.8 million bank loan to the city through a U.S. Department of Housing and Urban Development (HUD) program.
- On August 6, 1999, MARAD approved the deferral of MHI's missed June 1, 1999 "interest only" payment to December 1, 1999. This \$1.55 million payment was for the MARAD guaranteed loan with Fleet National Bank.
- On August 17, 1999, MHI's general contractor (and its subcontractors) for the shipyard modernization project walked off the job because of payment disputes of \$3 million. The general contractor claimed it had not been paid since April, when only a partial payment was made.
- On August 30, 1999, MARAD: (1) declared a "Contractor Default" and formally terminated MHI's general contractor for the shipyard modernization project and (2) called on the surety company to perform under the terms and conditions of the performance bond. According to MARAD's Deputy Administrator, negotiations with the surety company could take several months.
- As of September 14, 1999, MHI had not provided MARAD any new or updated applications for shipbuilding projects. As discussed in our July 1999 report, the only potential shipbuilding project (with Intermare) has

unresolved issues and, therefore, is questionable. Without shipbuilding projects, MHI may not have sufficient revenue to pay its debts.

These events have reinforced and made more serious our previously reported concerns. Taken together, these events will delay completion of the shipyard for an indeterminate period of time and further increase the risk of default by MHI on the guaranteed loan.

The risk reassessment of the loan guarantee recommended in our prior report remains important but will be of limited value until MARAD and MHI have concluded negotiating with the surety company. However, MARAD needs to take immediate action to protect the interests of the United States Government and minimize potential losses. Specifically, MARAD should freeze the uncommitted funds in MHI's escrow account, identify the assets and properties owned or acquired by MHI, and ensure they are safeguarded from loss or unauthorized disposition. This is important because, in the event of default on the guaranteed loan, the United States Government has a first priority lien on all assets and property owned or acquired by MHI.

As of September 14, 1999, MARAD estimated that of the \$12 million remaining in the escrow account, approximately \$7 million was not committed to pay for equipment ordered and services rendered. However, MARAD has not identified all of the assets owned or acquired by MHI.

### **MHI's Ability to Make December Payment is Doubtful**

On August 6, 1999, MARAD approved MHI's request to defer the June 1, 1999 "interest only" payment until December 1, 1999. As a result, MHI will be liable to pay Fleet National Bank approximately \$5.1 million on December 1, 1999. This amount includes the missed June 1, 1999 "interest only" payment and the scheduled semiannual interest and principal payment. MHI's ability to make this payment is predicated on a potential shipbuilding project (utilizing Title XI loan guarantees), but that project has unresolved issues.

MHI officials continue to identify the Intermare shipbuilding project as the only potential source of revenue from which payments could be made on the guaranteed loan. Intermare's application for a Title XI shipbuilding loan guarantee was submitted to MARAD in January 1996. MARAD has not made a decision on the application because there are unresolved issues regarding how MHI would implement the shipbuilding project. MARAD has requested specific additional information on how MHI intends to satisfy the requirements

under the Title XI loan guarantee program for the proposed Intermare contract. As of September 14, 1999, MARAD had not received the information it needs to consider and approve the Intermare application. MHI has not identified other shipbuilding projects that could generate revenues to repay the guaranteed loan.

MHI has other significant debts in addition to the MARAD guaranteed loan. These include the balance on a \$7.8 million loan to the city of Quincy obtained through the HUD program. MHI is in arrears on this loan. On August 1, 1999, MHI missed a payment of \$258,880 to the city of Quincy, Massachusetts.

### **Shipyard Completion is Uncertain**

On August 17, 1999, the general contractor (and its subcontractors) on the Quincy shipyard modernization project walked off the job. The general contractor was protesting payment disputes of \$3 million. The general contractor claimed it had not been paid since April, when only a partial payment was made. MHI notified MARAD of specific alleged defaults by MHI's general contractor. MHI requested MARAD's consent in terminating the contract with its general contractor and making a demand under the performance bond issued in connection with the contract.

MARAD immediately requested that MHI and its contractor "observe a cooling down period so that MARAD could better understand the issues and see if the parties could come to some working reconciliation of their differences over the contract." An estimate by an independent engineering firm concluded that the shipyard is 80 percent complete.

Based on discussions with representatives of MHI and its general contractor, MARAD concluded that MHI was unable to resolve its differences with its contractor. MARAD noted that each of the parties to the contract had declared the other in default of its obligations under the contract. Based on information provided by MHI and its general contractor, MARAD concluded that the general contractor might be in breach of material contract promises.

On August 30, 1999, MARAD, with the consent of the Secretary of Transportation, declared a "Contractor Default" and formally terminated MHI's general contractor from the shipyard modernization project. Also on August 30, 1999, MHI notified its general contractor that the contractor's performance bond would be called immediately. According to MARAD's Deputy Administrator, negotiations with the surety company could take several

months. Work on the shipyard stopped and the estimated completion date has slipped for an indeterminate amount of time.

### **Escrow Fund, Property and Equipment Could Reduce Loss**

MARAD's guarantee to Fleet National Bank for MHI's loan is for \$55 million<sup>2</sup>. However, this may not represent the amount of loss if MHI were to default. For example, the loss could be offset by any funds remaining in the escrow account and the residual value of property and equipment owned or acquired by MHI.

MARAD's letter commitment to MHI for the loan guarantee contained provisions to protect the interest of the United States Government. One provision granted the Secretary of Transportation a first priority lien on all assets, land, and other real and personal property owned or acquired by MHI.

As of September 14, 1999, approximately \$12 million remained in the escrow account. Of this amount, approximately \$5 million is committed to pay for equipment ordered but not yet received at the shipyard. According to MARAD, this amount is not in dispute. In the event of default by MHI, MARAD could use the funds remaining in the escrow account to reduce the Government's loss on the loan guarantee.

Also, MARAD has the right to assume ownership and sell MHI's assets and property in the event of default. For example, of the \$43 million already spent by MHI from the guaranteed loan, approximately \$26 million was for structures and equipment purchases. According to MARAD's records, this includes a variety of items such as computer systems and software, pumps, machine tools, welding equipment, forklifts, cranes, and a truck. However, as of September 14, 1999, MARAD had not conducted a physical inventory to identify all assets and properties owned or acquired by MHI.

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<sup>2</sup> In the event of default, MARAD is required to pay Fleet National Bank interest accrued on the guaranteed loan from December 1, 1998. Interest accrues at approximately \$8,470 per day.

## **Recommendations**

In order to protect the interests of the United States, we recommend MARAD immediately:

1. Freeze the uncommitted balance in MHI's escrow account until negotiations relating to the performance bond are concluded.
2. Conduct a physical inventory of all assets and property owned or acquired by MHI for the shipyard.
3. Ensure that the assets and property identified in the inventory are safeguarded from loss or unauthorized disposition.

## **Management Comments**

On September 14, 1999, we met with MARAD's Deputy Administrator and Title XI program staff regarding our recommendations. These officials generally concurred with this report and our recommendations.

## **Action Required**

Please provide written comments within 15 days on specific actions taken or planned. We appreciate the courtesies and assistance extended by MARAD to our staff during this audit. If I can answer any questions or be of further assistance, please feel free to contact me at (202) 366-1992, or Tom Howard, Deputy Assistant Inspector General for Maritime and Departmental Programs, at (202) 366-5630.

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