

LEGAL ASPECTS FOR MILITARY PROCUREMENT

18 November 1948

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## LEGAL ASPECTS FOR MILITARY PROCUREMENT

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GENERAL HOLMAN: Gentlemen: There are always two questions which the prudent and successful purchasing or contracting officer will ask himself before making a commitment. Those are: "Where are the funds?" and "Are there any legal restrictions or impediments to handling this contract?" After a contract has been signed, sealed, and delivered, it is very late in the day to do any backtracking.

Fortunately for the Army, there is an office where our procurement people can get answers to complex legal problems. They not only get answers, but they get right answers. The path to the door of General Brannon is not a jungle trail; it is a very well-traveled thoroughfare.

Our speaker today has had wide experience in the field of military procurement and the legal aspects of procurement. He has also the unique distinction of being the Army's first Procurement Judge Advocate. Today we are considering the "Legal Aspects for Military Procurement," and I can assure you that you are in good hands.

I take pleasure in welcoming to the College and to this platform Brigadier General Ernest M. Brannon who is the Assistant Judge Advocate General for Procurement, United States Army. General Brannon.

GENERAL BRANNON: General Vanaman and gentlemen. It is a privilege to talk to this group. I went to the Industrial College a long while ago myself and this is the first time in a long while that I have had a chance to address one of the classes.

My subject this morning is a very broad one, this matter of the legal aspects of procurement. There are a lot of lawyers in the Armed Services working day after day trying to solve various questions in this field. Speaking from experience, it is hard work. You have to dig all the time. You can't expect in the short course of 25 or 30 minutes to cover more than a few high spots. I will, however, try to bring out some of the points that it seems would be of most interest to a class in this school. I will ask you to bear with me if my talk seems to be a little disjointed. I will have to go around and pick out a few of the more important points.

In any legal subject we can't be too dogmatic. You remember the old English king who said that all lawyers may do is to refer. It is difficult for anyone to say categorically, "This is the law." As one of my law school professors used to say, "All a lawyer can do is to predict what the courts will decide." He is supposed to be a trained guesser, but nobody can say, "Just this is the law, and nothing else." So you will have to bear that in mind.

The basic law now covering procurement is the Armed Services Procurement Act of 1947. Mr. Andrews, Assistant Secretary of the Navy, addressed you recently and went into some detail as to how that act was passed, how it was developed, and some of its more important points. I will try not to repeat the same matter that Mr. Andrews covered. However, I may necessarily repeat a few points.

There are various ways in which contracts may be classified. I had a rather interesting thing come across my desk this morning and, as a result, I brought it down in connection with these new regulations. We have this paragraph: "Documents coming within the purview of this regulation will include purchase contracts, sales contracts, leases, easements, proposals and acceptance documents, or other documents if in whole or in part an agreement between the parties which involves the payment of funds hereinafter referred to as contracts."

I don't think a classification of that kind--I read it to you as a matter of interest--is very helpful. I think that a classification that will be more useful here is one on the basis of the risk. Primarily a contract is a device or instrument for allocating the risk in a business deal between the different parties. On that basis, we can classify contracts for convenience into three general groups: First, the fixed-price contract, where the maximum risk is on the contractor; second, the cost-plus contract, where the maximum risk is retained by the Government; and, third, what we call the hybrid contract, which partakes of the nature of both, that is, a contract where we make some effort to split the risk between the two parties.

Mr. Andrews in his talk explained to you how the new procurement act generally requires competitive bidding, but provides a number of exceptions under which contracts may be negotiated. When we advertise for contracts, almost invariably they limit the advertisement to a fixed-price contract. It is very difficult to have any other type in a competitive-bid situation. In that type, as I said, the contractor has the maximum risk. He is the entrepreneur who takes the chances and expects to make a profit from his deal.

Now section 4(a) of the Act provides expressly that when contracts are authorized to be negotiated they may be of any type which the agency head thinks will best serve the interests of the Government. There is one proviso, however, that the cost-plus-a-percentage-of-cost contract will not be used. I am just going to take a moment to explain the undesirability, let us say, of the cost-plus-percentage-of-cost contract.

That type of contract was used to considerable extent in the First World War. In a way it is the simplest contract to make. You can start the man on the job and say, "Go to work. We will pay your cost, and we will pay 8 percent or 10 percent of your expenditures." Very simple.

The objection to the cost-plus-percentage-of-cost contract is that it places a premium on the contractor's running up the cost to the Government. In other words, the more he can make the contract cost the Government, the more profit he makes.

For that reason, Congress and the public generally are very much opposed to the cost-plus-percentage-of-cost contract. At the same time, there are some cases in commercial life where it is very useful. Where you have implicit confidence in the contractor, it is a simple arrangement, but because of that background of a situation where there is a premium on increasing the cost, Congress has prohibited the use of the cost-plus-percentage-of-cost contract.

Now sometimes when we use the expression "cost-plus contract," people think of "cost-plus-percentage-of-cost contract," but that is not necessarily true. A "cost-plus contract" is a contract under which the Government pays the cost, plus a profit determined in various methods. It may be a so-called fixed fee; it may be the target or body type of contract, or the evaluated fee. But "cost plus" does not necessarily mean "cost-plus-percentage-of-cost."

The cost-plus contract, other than percentage of cost, as I said, puts the maximum risk on the Government. The contractor takes relatively little or no risk on that type of contract. In wartime, of course, that contract is widely used, particularly the cost-plus-a-fixed-fee contract, which was common in the last war. In peacetime it is used to a considerable extent in research and development contracts where we enter into a deal and don't know what the research is going to cover and it is very difficult to determine whether any tangible results will come out of the contract. It is most convenient there to have some type of cost-plus contract.

Now there are various types of the third or hybrid type of contract. There are three main types. The incentive type Mr. Andrews discussed with you, I think, in considerable detail. I will not go over it again. There are two other types that are fairly common. One is the contract which provides for escalation, and one which provides for price revision. Those particular terms are not standard but are in fairly common usage and I will explain what I mean by each.

The escalation type of contract will come in a situation such as this: Suppose a contractor has entered into a large construction project in time of inflation and uncertain prices. He doesn't know what drastic changes there may be in prices during the course of the contract. On the other hand, let us say he is reasonably sure of the elements that go into the contract, that is the number of man-hours that will be required to complete the job and the amount of material. In other words, he knows

what is going in but he doesn't know what it is going to cost him. In that case, it might be convenient for the Government to assume what we might call the economic risk and the contractor assume the technical risk. If it requires more men or more materials, the contractor takes the risk. If, however, the prices go up or down, the Government may take the risk. We cover that in the so-called escalation provision. In other words, we have a fixed-price contract, but provide for a revision of the price up or down depending upon changes in cost of labor and materials or various elements that go into the making of the contract.

There is one thing, of course, that you must consider. If the contractor takes the risk, that is the entire risk, on a flat fixed price he must include in that price a considerable increment to cover possible contingencies, a good big element in the cost to cover possible fluctuations. When we put in an escalation provision, we have to squeeze out this amount for contingencies. In other words, it would not be proper to use the escalation provision unless, as a result of very careful cost analysis, you were sure that the contractor had not included in his base price those elements to cover these contingencies. In other words, we can't allow the contractor both to have his cake and eat it.

The price revision article is ordinarily used in contracts for the manufacture of unique items where the contractor doesn't know what the costs are going to be. There, again, if he makes a flat fixed-price contract, he has to include a considerable amount for possible contingencies, for the possibility of the contract costing him a lot more than he estimated.

In that situation we may start out with a fixed price, but have a price revision article providing that after a part of the contract, say one-third or one-fourth, has been performed, we will reconsider the price on the basis of the contractor's experience, his actual manufacturing cost experience up to that point, and then agree on a new price. The new price may cover the remainder of the contract or it may cover the entire contract. In a few cases we provide for more than one price revision, but ordinarily one at a fairly early stage in the manufacture. From that point on, of course, the contractor takes the entire risk.

Next is the question of what goes into the contract--taking these three general classes of contracts, what do we put into the agreement when we make it?

In the first place, the contract is not necessarily written. It may be verbal or an exchange of letters, but ordinarily it is reduced to a written instrument in order that the disbursing officer may have something definite on which to make payment when the vouchers are submitted to him.

In every purchase contract which the Government makes there are certain basic elements which must be incorporated the same as in contracts with individuals. In other words, there is the question of the description of the supplies you are going to buy, the quantity of supplies, the date of delivery, the price, the time of payment. Those things are just incident to any ordinary business deal for purchases, and they must go into government contracts.

However, there are a number of additional provisions that go into government contracts because of the peculiar position of the Government as a contractor. I am going to take a few minutes, gentlemen, to sketch for you this special position of the Government when it gets into the contracting field.

In the first place, the Supreme Court has held that the United States Government as an incidence of its sovereign power may make contracts within the sphere of its powers under the constitution. That may be through the instrumentality of the department charged with those constitutional duties of the Government.

Now there is an old principle of law that the sovereign cannot be sued without his consent. Under the common law the king could not be sued. That rule has come over to the United States, and the United States Government cannot be sued without its consent. If Congress did not consent to be sued, a Government contract would be nothing but a moral obligation, and as such not enforceable at law. However, Congress has consented for the United States to be sued in contracts and, as a result, Government contracts stand on the same footing as other contracts. You can sue the Government just the same as you can sue an individual for a breach of contract.

The courts have often said that when the Government enters into a contract it stands on the same basis as any other contractor. That is true in a general sense. Government contracts are subject ordinarily to the same laws as other contracts, but that is not strictly true. In the first place, the courts do not treat the Government the same as an ordinary contractor. Because of the great public interest in government contracts, the Government receives special treatment in the courts.

Second, the Government can act only through its agents. Agents are all public officials. The Supreme Court has held that every agent or officer of the United States, from the President to the lowest, holds his office subject to certain limitations. In other words, he has only the authority conferred upon him by law. Therefore, government agents are in some respects treated differently from agents of private parties.

The third is the sovereign aspect of the Government. When private parties make contracts, their contracts are subject to the sovereign power of the state. In a government contract you have this situation: The Government is both the contractor and the sovereign, which puts it in a very difficult situation from the ordinary contractor. Congress in its sovereign capacity has passed a number of laws applicable to the Government in its contractual capacity, and it is that group of laws which influences so much the type or the contents of government contracts.

Because of those laws, we have a lot of what we may call "boiler plate" which has to go into government contracts. Some of these laws require that particular provisions be inserted. The others do not require a particular provision but because of that law the provisions of the government contract must be drawn with that law in mind. I will explain some of the more important provisions.

The first is the provision that officials will not benefit. The basic law that no member of Congress may share any benefit under a government contract is included as a contract provision. I may say here that I have seen some British contracts which contain an almost identical provision with respect to participation in British government contracts by members of Parliament.

Next is the covenant against contingent fees. That is a covenant under which the contractor alleges that he has not secured that contract as a result of any agreement to pay a percentage or brokerage or contingent fee. There are two purposes for that provision: First, to discourage the use of personal influence in securing government contracts; second, to eliminate unnecessary middlemen. The government policy is to deal directly with the producer not through unnecessary brokers or middlemen. That was first put into government contracts during the First World War and for a period up to the passage of the Procurement Act it was a matter of Executive order. By directive of the President such a provision was included. Now it is an actual requirement as far as the Armed Services are concerned in the Armed Services Procurement Act.

Next is the Buy American Act. We have a provision of law which requires, subject to certain exceptions, that our purchases of supplies must be limited to supplies manufactured or produced in the United States. Therefore, we have in the contract a provision under which the contractor certifies, if it is not an exceptional case, that the product which he will furnish is in fact produced or manufactured in the United States.

We have a provision covering the assignment of claims, but I won't go into detail.

There are two provisions based on payments. One law of Congress provides that payments for supplies and services shall not be made until the supplies or services are actually received. Therefore, in drafting the payment provision, it must be drafted in accordance with that law; that is, the payment will not be made until delivery of all or a part of the supplies. You may make partial payment on partial delivery but the payment article in government contracts must be drafted with this law in mind.

Now in the present contract act there is a provision under which in certain cases advance payments may be made. If it is an appropriate case for advance payments, then we have an advance payments article drafted in accordance with that provision.

Certain acts of Congress cover wages and hours or working conditions. The first is the old Eight-hour law of 1892, an act which originally provided that under certain types of government contracts labor is not to be permitted to work more than eight hours in one day. That has been subsequently modified to permit work in excess of eight hours on the payment of time and a half.

Next, the Davis-Bacon Act which applies to contracts for construction, operation, and repair of public buildings or public works. It requires that the contractor pay the prevailing rate of wages in the locality. The Secretary of Labor determines the prevailing rates in various localities and in the construction contract, therefore, we have a provision setting forth these rates and requiring that the rates be paid by the contractor.

We have the so-called Copeland anti-kickback act which goes one step further and says that not only must he pay the rates, but if he takes any wages back he can go to jail. There is a contract provision to aid the penal statute. There are certain pay roll reports which he makes and which give us a basis or a check on whether or not there has been any kickback.

Next is the Walsh-Healey Public Contracts Act. That is an act applying to the purchase of supplies in excess of \$10,000. That act has several provisions: It requires that the contract must be placed with a manufacturer or regular dealer; it provides for certain rates of pay that must be made and certain working conditions, particularly with respect to the employment of women and minors.

If the contract comes under the new Renegotiation Act, we must have a provision stating that it is subject to renegotiation. I will leave the discussion of the Renegotiation Act until later because it covers several different aspects of the subject.

There are two provisions which are required by Executive order: One is the provision with respect to convict labor. Many years ago, I think in the time of Theodore Roosevelt, an Executive order was issued requiring that this convict labor provision be included in government contracts. It, in effect, prohibits the use of convict labor by a contractor. It was passed at a time when it was fairly common in some circumstances to hire out state convicts. Now that practice is so well ended that the provision has very little effect.

The other is a provision which was inserted by Executive order during the last war and is still in effect. It prohibits a contractor from discriminating against any employees on the basis of race, creed, color, or country of origin. That is required to go in all contracts, although it is not a provision of law.

Now, in addition to the provisions required by law or required by Executive order, we have a number of provisions based on over-all government policy. You must remember that the Government is a big operator. Every year it makes thousands of contracts covering billions of dollars. As a result, there are many matters of contract policy which have been developed over the years. It wouldn't be practical, for example, to leave all these matters of policy to every contracting officer to decide every time he had to go out and make a contract. Not only do we have certain standard forms, but we have certain standard policies which apply to certain situations which occur time and again. I will just mention some of the more important ones.

First, government contracts have a so-called "change" article which permits the contracting officer to make certain changes in the drawings, specifications, crating, packing, and so forth--relatively minor changes--but it does give the contracting officer the authority to make certain changes. He must make corresponding changes in price if it increases or decreases the cost to the contractor.

The second is the inspection article. We have an article providing for the type of inspection of the final product delivered under the contract.

We have a provision covering termination by default. In other words, what action will be taken in case the contractor defaults in the performance of his contract. In certain cases we have standard provisions for liquidated damages. If it seems desirable under certain types of contract for including a provision for liquidated damages in the event the contractor is in default, we have a standard liquidated damage article.

In certain cases we have an article providing for the termination of a contract for the convenience of the Government. I will discuss that termination for the convenience of the Government as a separate subject. I will not go into it now.

We have a provision covering government-furnished property. In many cases the Government furnishes either part of the material or certain facilities. We have to have a provision based on not only over-all policy but on the regulations with respect to accounting for government property, and so forth. We have to take that into consideration in drafting a provision for the use of government property or facilities by the contractor.

We have a provision on insurance. It is the over-all policy of the Government, not merely in contracting, but generally, to carry its own insurance risk. The government operations are so large and so diversified that it is unnecessary to have insurance companies to spread the risk and, as a result, the Government bears the risk. Consequently, when property is turned over to a contractor or when he leases government property, to determine what kind of insurance coverage he should have, we take that over-all policy into consideration.

On the other hand, there are certain instances where it is to the advantage of the Government to have the contractor carry some insurance coverage. For instance, in a cost-plus contract it may be an advantage to the Government to have him carry some kind of liability insurance on his automobiles. It is not so much a matter of shifting the risk but an administrative device for prompt settlement of such cases. In other words, it might cost the Government more to attempt to go out and settle damages for wrecks or accidents by contractors' trucks than to permit them to carry some insurance even though we pay the premium.

We have another provision covering taxes. There again the Government in its unique position of being sovereign is immune from state taxation. With respect to federal taxes we have this situation: Ordinarily, the courts hold that the Government does not tax itself. On the other hand, tax exemptions, that is the getting of exemptions, the administrative work may cost more than the exemption is worth. In either case the Government gets the money, whether the contractor is taxed, whether the procuring agency pays the tax, or whether the procuring agency gets the exemption. Of course, if you get an exemption, you may save the appropriation a little bit. Whether the administrative work to get the exemption is worth saving a little money for the appropriation is a question.

In the patent field we have a number of questions. I don't want to get into the details of patents, but we have the question of coverage which the Government will get from the contractor, that is patent protection from the contractor. In research and development cases we have a question of what patent rights the Government shall be granted by the contractor in the event some new invention results from the research or development contract. That is a matter of important over-all policy. The contractors in many cases want to keep all the patent rights. They are very chary of what rights they give the Government. The only way the contracting officer can be in a good bargaining position is to have a firm, fixed Government policy behind him.

Another matter is disputes. The policy of the Government is that all questions of fact be settled by the contracting officer, subject to appeal. In the Armed Services we have set up a board for hearing these appeals and we have a disputes article covering the method of appeal. So much for the provisions.

Now, gentlemen, I just want to remark at this time that while most of the government contracts fall into fairly standard patterns and many standard forms, from time to time we run into a situation where a contract must be tailor-made. In other words, we must have particular provisions covering unusual situations. So that you cannot always count on using standard forms. I believe that Mr. Andrews and Colonel Phillips Smith covered the matter of the efforts we made under this Procurement Act to have in the three Armed Services standard procurement regulations. I won't go into that in detail at this time.

On this matter of contract terminations, which I mentioned before, in peacetime it has not been our practice to include a termination provision in all government contracts, that is termination for the convenience of the Government. It is always essential in war. It was used consistently in the last war and, to a large extent, in the First World War. However, under present conditions, particularly in view of the research and development program, it seems essential in many cases to have a termination provision in the contract.

Now, as you know, in 1944, Congress passed the so-called "Contract Settlement Act" which provided for the conditions under which Government contracts could be terminated. That act is no longer applicable. It applied only to war contracts. A new act was suggested to the last Congress but it was not passed. That act was largely the same as the 1944 act, except for these differences:

In the first place, it didn't apply across the board. It applied only when it was specifically included in the contract. There were certain elements relating to interim financing which were included in the war act and not in the peacetime act, but that is a matter of controversy. Some of the Services thought it should be included. That is a matter which is now under study.

Under the 1944 act, settlements were final, not subject to review by anyone except for fraud. Under the proposed act, settlement was not completely final. For example, in cost-plus contracts the settlement fee was final but not the settlement of disallowances previously made by the Comptroller General. That also is under study. I think I may sum it up by saying this: In our procurement regulations we can provide for terminations for the convenience of the Government. An act would facilitate terminations but is not necessary.

Now, gentlemen, I want to talk briefly about the situation which would exist in the event we were thrown into a sudden emergency and where we stand with respect to authorities in this field. I think Mr. Andrews explained to you that section 2c(1) of the new Procurement Act provides that when deemed necessary in times of national emergency any contract may be let by negotiation. Therefore, if we had a sudden emergency, we could immediately start negotiating all contracts and do away entirely with advertising and competitive bidding, which would be quite advantageous.

Second, I think section 5 of the act, as I mentioned before, provides for advance payments whenever the contract is authorized to be negotiated. In time of emergency, when all contracts can be negotiated, we can make advance payments under any contract and to that extent we could finance the contractor and help him to get started, get his work going, and by immediate negotiation of contract provide for advance payment.

The "Assigned Claims Act" has a provision under which counter claims can be limited to a particular contract. It facilitates private financing of contracts. We don't ordinarily use that provision in peacetime, but we could resort to it in time of war and it would go far in helping the contractor to get private financing. That is about where we stand on the matter of financing contractors as the law is now.

In addition to these acts which we have on the books and a few old ones from the Second World War, which have not entirely expired, the National Security Resources Board is working on the draft of an omnibus bill. The present plan is to submit that bill to Congress, to be passed in time of peace and to become effective in time of war. I don't know what the final result will be, whether Congress will buy that, but whether they do or not, this omnibus bill will provide an excellent starting point. Even if not enacted by Congress, separate chapters--if not the whole bill--can immediately be submitted to Congress on the outbreak of hostilities.

I won't go over all the provisions of that bill, but will mention a few which relate directly to procurement:

One is emergency contracting authority which is virtually a reenactment of Title II of the First War Powers Act.

One is defense facilities which authorizes the use of funds for erection or for rehabilitation of manufacturing facilities.

Production loan guarantees is intended to permit the Government to guarantee loans in order to facilitate further private financing of war contractors.

Priorities and allocations which will authorize the President to acquire priorities in the performance of government contracts and to make allocations.

The mandatory order provision which doesn't differ materially from Section 120 of the National Defense Act and the provisions of the Selective Service Act of 1940 and 1948.

Exemption from antitrust laws.

Authority to requisition.

Contract price adjustment.--Again I may say on that, the Contract Price Adjustment Act is a reenactment of a statute passed in 1944 but which was used only in one or two instances. The Services recommended that chapter be deleted from the omnibus bill.

Finally, a provision for renegotiation.

Gentlemen, that brings us up to the question of renegotiation. That is a big subject and I can hit only a few high points in this talk. I have left it to the last because of its relation to the most difficult part of this whole problem, namely pricing. What kind of prices are we going to give under these contracts in order to prevent excess cost and excess profits to the contractor? I don't want to get too much into the discussion of war economy. I think this entire cross section of private pricing is difficult in time of war--particularly under a war economy.

I do want to say briefly, though, that this question of profiteering in war is an old one. We had it in the Revolutionary War, the Civil War, the Spanish American War, and, to a large extent, in the First World War. The important thing is that in the First World War, as the result of excessive profits, some effort was made to curb them. We had high income taxes, some allocation, and some price fixing by the War Industries Board, which no doubt you will study here. There was considerable public interest in this effort to curb excessive profits of contractors, strong public sentiment against war profiteers. The Armed Services are very sensitive to permitting excessive profits as a result of their contracts.

However, gentlemen, I want to stress this: It is my view and I think it is pretty generally held, that, while this matter of excessive profits has a lot of public appeal, the most important consideration is not the question of contractors getting rich. The first consideration, of course, is to get the munitions which you need for war. You have to do that whether high profits are made or not. The second consideration is the question of cost. In other words, we don't want to get any

arbitrary idea about preventing profits because by arbitrarily curbing profits you are likely to increase the cost of war materials to the Government and that will lead to more inflation. Finally, of course, is the question of curbing profits, but I think it is certainly the third in importance.

Now in the early days of this war, particularly following Pearl Harbor, we had a typical war economy, the terrific rush, the demand for supplies, with contracting officers under terrific pressures to get out contracts, get supplies, and get going. As a result, a lot of contractors were making excessive profits. It was not necessarily their own fault. In many cases they went into these contracts without knowing what the cost was going to be to themselves. They had to increase their facilities; they had to train a lot of inexperienced help; they went into a field, many of them, with which they were not familiar, and they had never been making this stuff. They just didn't know what the costs were going to be. The situation could be met in some part by a provision for price revision or escalation, by which they would try to shift some of the risk. But those things were not sufficiently effective. They helped, but they didn't solve the problem.

As a result, by 1942 there was strong public feeling against the excessive profits which were being made, and the matter was raised in Congress. We had proposed the so-called Case amendment. That amendment, which was offered by Mr. Case of South Dakota, and which, I believe, actually passed the House, would limit profits to six percent. The Services felt that that would be fatal, that it would interfere largely with getting contractors and would take away too much incentive from good contractors. As a result of battling the matter back and forth and after extensive hearings, Congress came up with the Renegotiation Act of 1942, which provided, in effect, that after a contract was completed, it would be renegotiated to determine whether or not the contractor had made an excessive profit.

That act was amended in 1943. At that time Congress prescribed in general the factors that would be taken into consideration in order to determine what were excessive profits. There were seven provisions in that part of the bill:

1. The efficiency of the contractor, with particular regard to the attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower.
2. Reasonableness of costs and profits, with particular regard to volume of production, normal prewar earnings, and comparison of war and peacetime products.
3. Amount and source of public and private capital employed and net worth--in other words, the question of what the contractor put in in the way of his own facilities.

4. Extent of risk assumed, the idea that the less the risk on the contractor, the less profit he was entitled to receive.
5. Nature and extent of contribution to the war effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance.
6. Character of business, including complexity of manufacturing technique, character and extent of subcontracting and rate of turnover.
7. Such other factors, the consideration of which the public interest and fair and equitable dealing may require. Those were the factors which were used for actual renegotiation.

Now it is hard to tell how much renegotiation helped. I think there is no question that it did a lot to curb excessive profits. We recovered from renegotiation about ten billion dollars, of which about seven billion would have been recovered as a result of excess profits. In other words, when you take away profits, you, of course, cannot tax that amount as excess. The actual net recovery, exclusive of taxes, was something like \$3,260,000,000, we actually got back, which, of course, was a substantial amount. In addition to that, there were many contractors who, knowing of renegotiation, deliberately cut their prices rather than keep their prices up and then have to renegotiate them and pay money back--a matter of public relations. So you can't tell how much we saved.

The best summary of renegotiation I have seen was made--and I am going to take the liberty of reading it--by Mr. Rocky of the Navy Department in a hearing before the House Ways and Means Committee. He said:

"The renegotiation law is an attempt to adapt our profit economy and system of free competitive enterprise to wartime conditions. It is strictly a war measure, adopted as an alternative to a rigid formula for profit control, such as contained in the Vinson-Trammell Act, and in place of profit control through taxation.

"Experience has shown that any method that fixes a ceiling on profits when applied to all cases, whatever the facts and circumstances, results in excessive profits to some and inadequate rewards to others. Profit control through taxation not only has all the disadvantages of a rigid formula but also serves to encourage high cost production. No fixed formula will control war profits, and at the same time, make adequate allowance to a contractor for his risks, performance and contribution to the war effort.

"The aims and objectives of the renegotiation law are (1) to encourage efficiency and volume in war production; (2) to keep the costs of munitions and materials of war under control; and (3) to prevent the realization of unconscionable profits by war contractors. In short, the law is not a punitive measure, a revenue measure, nor a regulation measure. It is a pricing statute and as such is an essential part of wartime procurement. I cannot emphasize this fact too strongly."

Gentlemen, in conclusion I want to say that no one can tell how effective renegotiation is going to be in the next war. There are some disadvantages to renegotiation. I think there is no question that if you have a renegotiation statute you discourage contractors somewhat in making a close price and you take away some of the incentive of the contracting officer. It is very easy for the contracting officer under pressure of war to say, "Well, renegotiation will take care of it. I don't have to worry about prices." I think renegotiation is certainly not a cure-all. If well administered, it will be an effective instrument. It will not obviate the necessity for good business sense or careful price analysis or for intelligent contract provisions. We will still have the pricing problem, even though we have renegotiation. If poorly administered, renegotiation can be worse than useless. It can amount to nothing more than a taxing measure. In effect, divorced from procurement, it will do more harm than good.

We presently have a limited renegotiation statute on the books. It applies to all purchases under the provisions of this Second Deficiency Appropriations Act, the act for the 70-Group Aircraft Program, all expenditures under that, and in addition to all other expenditures for aircraft and aircraft parts. It may be that the way we administer the present peacetime Renegotiation Act will have a good deal of effect on how effective renegotiation will be in a future war.

That is all, gentlemen.

MR. MUNCY: There is one other topic that General Brannon will discuss with you briefly before we take the questions, namely, Letters of Intent. It would be well to have that discussed at this time in view of the fact that one of the seminars this afternoon will take up military procurement contract forms and clauses.

GENERAL BRANNON: Gentlemen, after graduating from the Industrial College, I spent a year in the Planning Branch of the Assistant Secretary's Office. One of the acute problems on which we worked at that time was how we would place contracts in time of emergency, how we would get the program under way in a hurry without taking the long time necessary to negotiate these involved contracts.

The best thought I could come up with at that time was to use section 120 of the National Defense Act, that is giving contractors compulsory orders. That was not favored very much because during the First World War compulsory orders were used only as a device for the contractor who wouldn't play ball. That was the last step. When we couldn't get a man to come in any other way, we issued a compulsory order. For that reason, there was a lot of feeling against it; people didn't want to use it.

There was another objection when the actual time came. Section 120 of the National Defense Act says "In time of war or when war is imminent." In 1940 nobody wanted to concede that war was imminent to the extent of bringing section 120 into play. It was pretty imminent but nobody would officially say so. So we couldn't use section 120 even if we wanted to.

I may say that device would have this advantage. It would give the contractor complete protection, in the case of a compulsory order, for the reason that we could make a contract and if it didn't go through we could pay him whatever his costs were. It was a device which would protect the contractor in immediately getting under way in production. What actually happened was, since we couldn't use section 120, somebody developed the Letter of Intent. I would have been proud if I had thought of it. I helped in putting it over, but it wasn't my idea.

The Letter of Intent worked this way: In the early stages, particularly in the summer of 1940 after the fall of France when we really started our procurement program in a big way, the first bottleneck was in trying to get people into production and get some sort of machine tools. Rather than wait for the negotiating of a complete contract, we hit on this device of the so-called Letter of Intent. Under that, the contractor would be given a letter stating that the Government intended to give him a contract and to negotiate the details. In the meantime he was authorized to go ahead with his tooling up to a certain amount--half a million or a million dollars--in preparation for receiving this contract. There was a further proviso that, in the event the parties were unable or for any reason did not negotiate a formal contract, the Government would reimburse the contractor for the cost he had been put to for the tooling operation.

The Comptroller General agreed to go along with this plan and permitted us to draw up a little half-page letter to enable these fellows to get started on tooling--which was the first step anyway--and, in some cases, assemble special materials. The letter proved to be a very effective device to get the program under way. It covered a period of time and what the contractor would have to do in those weeks which were required to negotiate the large number of formal contracts.

Subsequently that was expanded a little bit to the so-called Letter Order or Letter Contract. The latter was the most common, and under it we would enter into a very informal agreement with the contractor, stating, "We propose to give you a contract to produce an airplane"-- tanks or whatever it was--"You are authorized to go ahead and make expenditures. If we are unable to agree on a contract, you will be paid."

The difference between the Letter Order and the Letter of Intent was that under the Letter Order the contractor actually agreed to go ahead with the work. Under the Letter of Intent he was not bound to go to work. If he bought some machine tools and we didn't make the contract, he would be reimbursed. If he got the contract all right, that cost would be included. But he did not obligate himself to do anything. Under the Letter Order, he did agree to go ahead with the work. Of course, the Letter Order provided that it would be subject to the various provisions of the formal contract. I believe that covers it briefly.

GENERAL VANAMAN: Would you touch on the reaction of the banks to the Letter of Intent and the Letter Order? That is, could a contractor based on either one of them receive consideration from the banks in order to start his work?

GENERAL BRANNON: Frankly, I don't know as a practical matter how effective that was. Of course, after we had the Assignment of Claims Act, which itself was, after all, a war finance measure, the banks could get an assignment even under the Letter Order. I don't know about the Letter of Intent. I don't think there was anything there really to assign. But certainly he could under the Letter Order. Whether, as a practical matter, the banks were skeptical, I don't know.

QUESTION: General, I have a question about termination. Did I correctly understand you to state that it is not essential to have an act now? Would you define that a little bit, please.

GENERAL BRANNON: We can have in the contract a provision under which we state that at the discretion of the contracting officer, the Secretary of the Army, or the Secretary of the Air Force the contract may be terminated; that clause will provide the conditions under which the contractor will be paid. It can be by either formula payment or negotiated payment.

The old idea was formula settlement. In other words, we would pay the contractor the contract price for everything he had completed; we would pay him for the work in process, and ordinarily some profit on it. We would not pay him, however, for the unearned profit on the contract, that is, the profit he would have made if he had completed the contract. In other words, he got his cost, he got the profit on the work he had done, but no unearned profit.

We can put that kind of provision in a contract. We can even put in a contract a provision for a negotiated settlement. The main difference is that it doesn't have the finality which it had under the Contract Settlement Act. Under that act, the Comptroller couldn't go back and say, "This was a poor settlement and you should have done this or that." It was final except for fraud. Under the termination provision, it wouldn't be final. We could go ahead and settle with the contractor, but it was subject to audit by the General Accounting Office. That is about the only difference. As I said, an act would be a convenience, but it is not necessary.

QUESTION: I think you said, sir, that the Government got back some ten billion dollars by renegotiation, of which some seven billion dollars would have come back under income tax anyway, leaving a net of three billion dollars. I wonder if you have any idea how much of that three billion dollars would have been spent in costs of administering the renegotiation. In other words, the income tax was not the only thing that would come off the ten.

GENERAL BRANNON: A relatively small amount. I don't know exactly, but as I remember it, something like 30 or 35 million dollars, a relatively small percentage for the actual administration of the Renegotiation Act.

QUESTION: You mentioned the subject of patents. That opens up the whole field of monopoly rights granted by the sovereign and their relationship to contracts in time of war. Would you care to discuss that?

GENERAL BRANNON: Yes, I will discuss that briefly. There is a lot of discussion on patent rights. As you know, there is a considerable school of thought that this monopoly provision should not exist at all, so there has been a recommendation made to the President that in all of our research contracts we take all patent rights and immediately dedicate them to the public. In other words, if the Government pays for the patent, it should be dedicated to the public.

The Armed Services are opposed to that for this reason: If we were dealing only with professional research people, paying the entire price, that would be proper. It is our policy in those circumstances to take the patent rights and dedicate them. However, we don't have enough research facilities of that type in the country. We have to depend to a large extent on industry--these big concerns, Westinghouse, General Electric, people of that kind--for a lot of our research work. Those people are not interested in research for the little profit they make out of it. They are interested because of the interest they have in the commercial features of the project. As a result, we feel this way,

that if the Government pays all or a substantial part, it certainly should have at least the license to use it for government purposes. But, if we insist upon the complete rights, we discourage a lot of people on whom we are dependent for our research work.

QUESTION: General, would you care to discuss what form of contract would be most attractive to a man who was already full time, heavily engaged in commercial business and making a big profit? What kind of contract would he be most likely to accept?

GENERAL BRANNON: Ordinarily, I think a contractor would like a fixed-price contract. He is the entrepreneur. He is in business for profit. He is willing to take the risk and make what profit he can; that is, assuming it is the kind of product where he can make a reasonably good guess as to how much his costs will be and what his profit will be. You may get into the research field, for example, where the project is so indefinite that it just isn't practical to make a fixed-price contract. He doesn't know whether he is going to be able to come up with something that will work. He may spend a million dollars trying to develop something without knowing whether or not, when he gets through, he can give us an instrument or a tool, whatever it may be. In those circumstances about the only practical thing is to have some kind of cost contract and let him use his best efforts.

QUESTION: What rules apply under a contract as to whether advance payments will be made? In other words, can a contractor receive advance payments whether or not he needs them?

GENERAL BRANNON: Well, we don't have to allow advance payments. As a matter of fact, the Services are pretty chary about authorizing advance payments. Of course, in wartime when you are calling on a man to enter into a strange type of work or maybe take on a volume of work far beyond his normal capacity or covered by his normal line of credit at the bank, the Government has to do something to help him. In peacetime, however, the general feeling is that a man who comes in for a contract should be able to finance it himself or through his bank.

In some of these research contracts, particularly with schools and universities, for example a state university, they may not have any capital available for this kind of work. They may have some excellent scientists who would like to go into this work, but they are almost precluded from doing this by their financial position. They are not in business; they have no capital available. In other cases, it may be we have a small outfit with particularly good engineering skill where we think it is an advantage to the Government to help them out financially. Maybe we think they are good engineers, but they don't have very much standing in the industry and may not be able to get the support of the bank for the necessary capital to swing a government contract. So it is done when, for good and sufficient reasons, the head of the

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department thinks it is to the advantage of the Government to finance this kind of contract.

QUESTION: We have learned that the contracting for research and development, particularly research, is somewhat limited; that is, their ability to make the contracts they want is limited, due to the fact that they cannot make them for a long enough period of time. I wonder if you would comment on that?

GENERAL BRANNON: Yes, we have before Congress, as you know, a research and development bill. One provision of that bill is that the money will be available for a period of four years after the fiscal year in which the appropriation is made. We think that is very essential in certain types of research. As it stands now, under our general rule, our appropriation is limited to two years after the fiscal year in which the appropriation is made. Of course, it is something that we have recommended to Congress, but until they pass it, we are stymied.

QUESTION: General, I would like to know what the Army's attitude is in regard to the Navy's revolving fund? Is it a question of constitutionality in regard to the Army and Air Force?

GENERAL BRANNON: You know the Constitution provides that Congress shall have authority to raise and support armies, but no appropriation for this purpose shall be available for more than two years. Now the question is, what funds are included in that terminology, "raise and support armies?" There is an old opinion of the Attorney General which indicated--or at least he expressed his opinion--that appropriations for general supplies was not within the prohibition. In other words, that the prohibition was concerned with the actual supply of the individual soldier. Our view, for example with respect to our research bill, is that certainly the funds for research and development looking toward the next war are not so directly related to raising and supporting armies that it would be unconstitutional to have money available for a longer period of time. Where to draw the line, I don't know. Funds for uniforms for individual soldiers and for food probably would be limited, but when you get into war research, the question of munitions, I don't know just where the line is drawn. But I think that the proper line is, as I say, what is directly related to this question of raising and supporting armies as divorced from the over-all national defense picture.

There is a considerable movement in the Army, considerable thought that we ought to try to get something like the Navy's revolving fund. It would have to be limited to some extent, but when it comes to the matter of constitutional law, we probably could go pretty far. As to how effective it would be, I don't want to speak on that.

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QUESTION: I believe, general, it has been common commercial practice for a supplier to bill his customer at the same time he ships his commodity out to his customer. The receiving company will pay that bill upon receipt of the bill, not waiting for the receipt of the material or for its inspection--any discrepancy being ironed out later by a matter of adjustment. By law, the Services are required to wait for the receipt of that material and its inspection before it is paid for. In some instances that might be an appreciable interval of time. Would you care to comment on the repeal of that law, as to its effect on purchases and prices that the Government has to pay and of stimulating business with the Government, making it easier for commercial concerns to do business with the Government?

GENERAL BRANNON: Well, there would be some objection to the repeal of that law. In the first place, the government operations are so big and varied. If two suppliers are dealing with each other and they know each other well, their respective credit managers know about the company, that it is all right. But when you come to the question of thousands of people with whom the Government has to deal, there are many cases when it would be disadvantageous to the Government. In other words, we would get stuck.

Now in addition to that, you have this question of competitive bidding, a matter of law where you have to award the contract to the lowest responsible bidder--very little choice about who can get the contract. As a result of that situation, it would be awkward if the Government had to go out and make payments to the fellow before the supplies were received. There again the government officer is a public official and if you try to discriminate and say, "Well, this is a big company, we are going to make payments to them," let us say to General Motors, "We will make payment to you." But to this little fellow, we say, "No, you can't get a payment; you are small; we don't know about your credit." It puts the official in an awkward position where he is dealing with various types of contractors. For that reason, I believe it would be objectionable to repeal the act.

QUESTION: We have heard on this platform that at least one of the Services is a little worried, or doesn't like, the cost-plus-incentive type of contract. In the example cited, which I believe was the Navy-Air Force contract, the thought has come to my mind, and to the minds of some of the other members of the class, as to the possibility of a cost-plus incentive type at a sliding scale which might either start low and go up, or start high and come down. First, is that legal, and, second, has it ever been tried?

GENERAL BRANNON: I think it is legal. We had that to a considerable extent in the First World War, the so-called "bogy" type of contract, target contract, under which the contractor would be given a certain fee

in addition to his cost. Then if he reduced the cost below the estimate, he got a part of the savings. The result often was that big profits were made, not because the contractor was efficient, but because the estimate was away out of line. A contract of that kind is good only if you can make a good estimate. If you can make the estimate good enough, it may be that you are almost in a position to have a fixed-price contract, or fixed price with some escalation, as to any sort of incentive contract, I think you can use it only where you have a pretty good idea of what the costs are going to be. Certainly it should be limited in such a way that a fellow is really being paid for good work, not for a bad estimate.

QUESTION: I would like to ask two questions: First, referring to the remark that was made about this revolving fund, do I understand that the objection of the Army not the Navy comes from the use of the words in the constitution "raise and support armies," rather than "Armed Forces?" Apparently the Navy considered it all along. I wonder why the constitutional provision doesn't say, "Army and Navy."

GENERAL BRANNON: It is just the way the constitution reads, "Raise and support armies." Then there is another provision that provides for the Navy. That provision didn't say anything about it. Maybe they forgot it. I don't know. I think, of course, the whole question was being considered at the time when they were thinking of the possibility of a dictator, and I guess they thought ships at sea wouldn't be of particular help to a dictator, whereas the soldiers actually in the country probably would. I think perhaps that is the reason they put it in one place and not in the other. They didn't look upon the Navy as being able to give so much support to a possible dictator as the Army could.

QUESTION: Under the "Buy American Act," the only exception is where the product is to be used outside of the United States, meaning beyond the jurisdictional control of the United States Government. It occurs to me that, although we have a military government of occupation and control in Germany, at least in the Western Zone of Germany, and Japan and Korea, or Japan now, that that is considered beyond the United States jurisdiction?

GENERAL BRANNON: It is considered beyond the United States jurisdiction, yes. It is a difficult question, but it is beyond. There are two ways of looking at it. One is the question of buying there. The other is letting them share the preferential treatment of American purchasing. Obviously, that is not within the intent of the law even though it could be stretched to come within the wording.

QUESTION: General, is there any requirement in present government contracts that union labor be used?

GENERAL BRANNON: No.

QUESTION: Will you discuss, please, the application of the various laws you have mentioned to purchases made, say, for the maintenance of the Armed Forces outside of the country or things that you buy outside and ship in? Do they all apply? If not, what do apply and what don't?

GENERAL BRANNON: They generally apply. For example, on the question of payment whether you can't pay for the supplies before they are received yes. One of the exceptions in the Armed Services Procurement Act applies to procurement outside of the United States and permits purchasing without advertising. That is specifically covered. To some extent the "Buy American Act" has exceptions with respect to products to be used outside the United States. Generally the various provisions apply.

There are a few others. For example, the rates of payment in certain of these labor laws which are essentially for the protection of American labor are not applied to contracts in foreign countries; the idea being that Congress is not interested in trying to regulate labor conditions in foreign countries. Therefore, these labor provisions do not apply. However, there is a case of that nature coming up in the Supreme Court. The Solicitor General is arguing that the labor provisions do not have any extraterritorial effect, although a New York court attempted to give the eight-hour law certain extraterritorial effects.

QUESTION: Prior to the war, we were using payment bonds to assure that employees of the subcontractor would be paid as well as the employees of the prime contractor. During the war, I understand, those bonds were not particularly used. Would you comment on the desirability or usefulness of bonds in general as well as what provisions were made to assure that subcontractors or their employees do get paid under government contracts?

GENERAL BRANNON: Here is the situation. The question of how effective bonds are is a matter of opinion. I think in many cases the Government doesn't get very much in the way of financial return for the premium it pays on bonds. However, we do get certain credit service from the bonding companies. The fact that your fly-by-night contractor can't get a bond may be a good reason for not awarding him a contract.

Now, on the particular point you raised, the question of the payment of bonds comes up in this way. Ordinarily under the laws of various states, you have the so-called "mechanics lien," where laborers and material men who furnish labor and materials for building a factory may have a lien on that factory for wages and materials. However, no one can get a lien against the Government. So in one sense the laborer who works on a government project doesn't have the type of protection which he would have on an ordinary building. Congress has sought to overcome that by

not giving a lien, but by requiring the contractor to carry this payment bond which requires him to pay these laborers and material men. I might say that where he has the performance bond no extra premium is required by the company for the payment bond.

During the war we had this situation. Almost all of our construction--that requirement under the so-called Miller Act ordinarily applies only to construction projects--was on a cost-plus basis. The contractor didn't get his money from the Government until he paid his labor. As a result, it was not deemed essential to require these payment bonds. From the nature of the project, there was no question of the contractor getting his money, going to Mexico, and leaving his labor to whistle. He didn't get the money until he paid his labor and paid for his material. In that situation it was considered unnecessary to pay large fees to bonding companies for a protection which would not serve any practical purpose.

QUESTION: Sir, the talk today was entitled "Legal Aspects of Military Procurement," and the term "procurement" itself, as well as several other terms we use in obtaining services and supplies for the Armed Forces, I believe, is very loosely defined. There is not a good definition which would stand up in international usage. For instance, why do we say "procurement" instead of "purchase?"

GENERAL BRANNON: I don't know. I will concede there is that confusion.

QUESTION: Breaking procurement down, there are four types of procurement: military procurement, procurement by purchase procedures, by capture of enemy equipment, and by pure stealing. Purchase is by far the greatest amount in dollar value. The implications to the individual may be receiving goods, making purchases, and then receiving payment for the purchase. Why don't we hit on that thing?

GENERAL BRANNON: You have a good point. I don't know the answer.

QUESTION: Two other expressions, sir, which are used in that same loose category and which do not stand up in fact are the terms billeting and requisition. We are prohibited from billeting, yet we used the term billeting throughout the war, when, in fact, we never billeted; we always paid for lodging. And requisitioning--we didn't requisition; we purchased. If that is in fact what we did, why not use the term purchase and get it over with?

GENERAL BRANNON: I can't answer that.

QUESTION: I would like to go back to this termination question. In last year's report by the student body on this termination question, they recommended that we have another such act as the 1944 act in case we have another war. They also stated that the subcontractor was not fully protected by that act. If those are true statements, what do you recommend for a future war?

GENERAL BRANNON: I don't know just where you mean that the subcontractor was not adequately protected. Maybe he didn't get complete protection, but there were very liberal provisions in the 1944 act for the subcontractor. I think 7d, e, and f of the act provided for payments to the subcontractor. In certain cases the Government would pay the subcontractor again even though they had already paid the prime. In certain cases that provision was employed where a subcontractor had made the subcontract, not so much on the basis of the credit of the prime contractor as at the urging of the military. He had gone ahead and taken a subcontract even though he was leary of the prime. In those cases, and in certain other cases, we could pay the sub even though the prime had already been paid. In certain other cases we would hold up payment to the prime and pay directly to the sub.

QUESTION: In other words, you think that act is clear in itself and we don't have to have anything else but that act?

GENERAL BRANNON: I am not prepared to say that there couldn't be some slight improvement. I say there are some substantial provisions for the protection of the subcontractor. You see this is a new act. Ordinarily, people make contracts and they can't just step out when they want to. This Contract Settlement Act gives the Government broad power to terminate contracts. We can stop a contract, but of course we expect to make payment on an equitable basis. Part of it was for the protection of subs. I concede that it could be polished off a little and have some additional protection for the sub, particularly in that situation where the contract is not completed and because of the termination of the contract for some reason before the work was finished the prime was not able to pay the sub.

QUESTION: General, I have heard of certain contracts which contained clauses prohibiting the disposal of that material by the Government under certain conditions. I believe it applied particularly to machine tools--you couldn't dump machine tools on the market after the war. Can you tell us something about that, please?

GENERAL BRANNON: I don't know just what situation that would be. Ordinarily, I take it, that would be in connection with some patent right. For example, many concerns of which one is the International Business Machines Company, have a policy of not selling their machines at all, only leasing them. I have in mind a case--not International Business Machines, a smaller company which makes a certain type of machine--where the policy was to lease them. The Government insisted that it wanted to buy. It didn't requisition, which it could have done. As a result of some negotiations, the company agreed to sell to us with the option to buy back. In other words, if we wanted to dispose of the machine, the company would have first right to buy it back. But I don't know just exactly the situation you have in mind.

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QUESTIONER: It was in connection with that option to buy back, rather than for the Government to dispose of the machine as it saw fit at the end of the war.

GENERAL BRANNON: We wouldn't do that where we have only limited patent coverage. In other words, a license under the patent might be limited to a situation such as that where we agreed to take it but to give him, let us say, the right to purchase it back.

GENERAL VANAMAN: General, I think I have proved my point that I made over in the lounge before the lecture started. I said that the members of this class have an outstanding interest in whatever subject they are studying, and I think I have proved that, have I not?

GENERAL BRANNON: I have been on the spot, yes, sir.

GENERAL VANAMAN: We want to thank you very much for your clear-cut discussion of what to most of us is a black art that is done with mirrors and crystal balls.

(6 January 1949--750)S.