THE ARMY INDUSTRIAL COLLEGE
Washington, D. C.

EMERGENCY LEGISLATION - WAR-TIME CONTRACTS

by

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January 11, 1936

AIC 148 (2/18/36)17

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The discussion this morning concerns the Legal Division of the Planning Branch, Office of The Assistant Secretary of War. The peace-time work of the Legal Division may be grouped under four general headings:

1. The preparation of drafts of emergency legislation,

2. The formulation of policies concerning war-time contract procedure;

3. Preparation of drafts of war-time contract forms in cooperation with the War Contract Board.

4. Miscellaneous legal matters.

In time of war the functions of the division are of the same general nature as in time of peace. Additional war-time functions would include the review of contracts that have been entered into by the government to assure compliance with law, and recommendations concerning policies for the adjustment of claims under war contracts.

In time of peace the Legal Division is concerned primarily with the emergency legislative program. An excellent historical study of the development of the emergency legislative program is contained in a monograph dated November 13, 1934 "Discussion of the Legal and Contract Phases of Procurement Planning," by Captain E. M. Brannon. As copies of that monograph have been distributed to you, I will not dwell on the history of the legislative program. Instead I will outline the developments of the past year in connection with emergency legislation and war-time contract forms.

During the last session of Congress the House of Representatives passed Bill H.R. 5529, entitled "An Act to Prevent Profiteering in Time of War and Thus Provide for the National Defense, and Promote Peace," which provided for the war-time mobilization of the nation's resources. The bill was completely revised by the Special Committee of the Senate to Investigate the Munitions Industry, and was further amended and favorably reported and recommended for passage by the Senate Military Affairs Committee. However, since title I of the bill comprised a complete revenue act, the Military Affairs Committee recommended that the bill be referred to the Finance Committee of the Senate for further consideration. When the first session of the 74th Congress adjourned, the bill had not passed and was still in the Senate Finance Committee.

Even though Bill H.R. 5529, 74th Congress, First Session, was not enacted by the Congress, the fact that its passage was recommended by two Senate committees after extensive public hearings, justifies its acceptance as a measure that to a considerable extent represents the will of Congress at this time. In its final form the bill had the approval of the War and Navy departments, except as to the provisions for taxation, taxation was considered to be a matter primarily for Congress and the Treasury Department.

The importance of this bill warrants a discussion of its provisions. In reporting out the bill the Senate Committee Investigating the Munitions Industry stated that the "measure is in no sense a military measure, but an economic measure, a considered plan to protect the economic society and to enable it to operate at the highest efficiency, not only for the armed forces of the nation, but for the protection of our society against economic collapse either in the midst of or at the conclusion of a war," and "to make the national defense invincible by means of a controlled universal use of all our natural and man-made resources." The bill is divided into six headings, or, in legislative terminology, titles

Title I - Income Tax.

Title II - Industrial Management Provisions.

Title III - War Resources Control.

Title IV - Securities Exchange Provisions.

Title V - War Finance Control.

Title VI - General Provisions.

Title I

Taxation

This title comprises a complete revenue act for wartime purposes. The normal tax rates on individuals and the surtax rates are drastically raised. The net effect upon personal incomes is the prevention of any annual net income of over $10,000.00 during a war year over and above all taxation.

The tax on corporations is also severe. The corporation tax is 15% on the first 2% of net income earned by the corporation after all deductions, etc.; 25% of all income above 2% and up to 6% and 100% on all income above that, as an excess profits tax. Thus the maximum income allowed corporations after payment of taxes would be 4.7% on their capital value. Corporations will pay their taxes quarterly. The war-time tax would remain in force during the war and until such time as the Congress may declare the emergency at an end. The object of this title is "to collect during the war by means of taxation enough taxes to pay the costs of the war and thus prevent the inflation by doing away with borrowing and the immense increase in the cost of the war which results from inflation." (1)

Title II

Industrial Management Provisions

This title authorizes a draft of industrial management. When in the opinion of the President the successful prosecution of the war requires it he may establish rules and regulations for the registration of all persons in the management or control of industry. This is intended to apply to persons in executive positions who are unwilling to cooperate in the industrial war effort. At the discretion of the President registered persons in any industrial plant or industry may be brought into the service of the government for the duration of the war and shall be subject to the jurisdiction of the War Department. However, the Secretary of War is not to interfere with the internal management of the industries. He may transfer registrants to any civilian service within the jurisdiction of the War Department. The compensation of such persons industrially drafted will be paid by the government at rates to be fixed by the President, and they may not accept any other compensation from any plant in which they rendered services during the war. Rules and regulations for the administration of this title would be made by the President and penalties are provided in the bill for violations of such rules and regulations. The provisions of this title are permissive, not mandatory.

(1) Senate Report No. 839, 74th Congress, First Session.

Title III

War Resources Control

This title gives the President very broad powers to control all of the resources of the nation by price fixing, licensing, rationing, priorities, and other measures for directing and unifying the industrial war effort.

The President by this title is granted discretionary war-time power and authority as follows To fix prices, to regulate commodity exchanges, to establish a system of priorities or rationing in favor of users most vitally linked with the prosecution of the war, to provide a system of licenses for organizations or persons engaged in manufacturing, mercantile, or public service industries, to regulate the sale, use, transportation, manufacture or distribution of any product, to requisition any product and to sell or otherwise dispose of such products, to enforce regulations against waste hoarding, speculation and profiteering, to commandeer any manufacturing plant or other establishment. The President, of course, may not find it necessary to invoke all of these powers.

The President is also authorized in this title to establish as many agencies as he deems necessary to execute the functions of control over war resources. The appointment of administrators to exercise the powers granted is also authorized. The President could regroup, redistribute or reassign the duties and functions of the procurement of war supplies for the military and naval establishments. In the World War, Congress did not grant such powers to President Wilson until the passage of the Overman Act on March 20, 1918.

"Just compensation" is provided for persons who comply with any requisition of their property by the Government. What constitutes just compensation is to be determined by the President but it is not to include loss of profits or anticipated profits. Those persons not satisfied with the amount of compensation to which the government decides they are entitled, are to be paid 75% thereof and they may sue the government at the close of the war for such amount as added to 75% will make "just compensation." The bill confers jurisdiction on the United States District Courts to hear and determine such disputes.

The effective date of this title, if the bill were enacted into law, would be "upon the declaration of Congress that a state of war exists between the United States and any foreign power and that the existence of such state of war creates a grave national emergency or upon the declaration by Congress that a grave national emergency has arisen owing to the imminence of declaration of war owing to the existence of a state of war between two foreign powers."

Title IV

Securities Exchange Provisions

This title empowers the President by proclamation to close all security exchanges for the duration of the war should he see fit.

Title V

War Finance Control

This title creates a War Finance Control Commission of five members named by the President. No security issue in excess of $100,000 may be offered for public or private sale unless approved by the War Finance Control Commission. The Commission may advance the necessary funds to any corporation or agency engaged in production essential to the prosecution of the war.

Title VI

General Provisions

This title provides that any person convicted of willfully violating any of the provisions of the Act or any of the rules or regulations made thereunder shall be fined not more than $100,000 or imprisoned for not more than one year, or both, together with the cost of prosecution.

The effective date of all the titles of the Act except title III would be "immediately upon the declaration by Congress that a state of war exists between the United States and any foreign government and that the existence of such state of war creates grave national emergency." Title III includes an emergency owing to the imminence of a declaration of war.

It is difficult to prophesy whether the bill will be enacted into law at the next session of Congress. The War Department favors the passage of the industrial control provisions of the bill. On April 9, 1934, Colonel Harris presented the War Department viewpoint before the Special Senate Committee Investigating the Munitions Industry. He said in part:

> "The Government control over industry as applied at the close of the World War was developed only after months of painful trial and error. This Bill will perpetuate the best features of that organization which were proved under actual war conditions. However, the proposed agencies will, in general, have much greater power than was exercised by corresponding bodies during the last war. Their authority being based on legislative sanction will permit quicker and more direct action. If this Bill is enacted into law, the ar and Navy departments will be able to base their industrial war plans on definite authority and the President will be empowered to put such plans into immediate effect. The Government will thus be able to secure a firm grip of the economic situation at the very outset of a war.
>
> In closing, I wish to stress the deep interest of the War Department in any fair, reasonable and effective movement which will minimize profits in war. The three essentials of war are men, money and munitions. Victory cannot be achieved without a plentiful supply of each. I must, therefore, in the name of the Secretary of War, again warn that any measures adopted must not be so restrictive or binding in character as to prevent necessary production, since any failure to produce munitions when needed may be paid for, not in dollars and cents, but in human lives and the consequences of possible defeat."

WAR-TIME CONTRACT FORMS

War-Time Contract Factors. Today the government uses standard contract forms. In 1917 no such standard forms for government contracts were in use. Each department devised its own forms. Consequently there were over 400 different government contract forms in use when the United States entered the World War. Nor had standard forms been adopted to meet the special economic situation created by modern war.

As a result of our World War experience, in our peace-time planning we recognize the fact that war-time conditions vitally affect the contractual relations of the government and industry. In some respects those contractual relations are affected favorably, in other respects they are affected unfavorably. On the favorable side the World War revealed the prominence of public spirit as a factor in war-time enterprise, war service infused a new altruistic element into our economic life. Another outcome of the war was the discovery of vast powers of cooperation between private enterprise and govermental authority in the face of a war emergency. The traditions of American business had theretofore been those of antagonism between private enterprise and government. But in the war emergency this antagonism practically disappeared. An unfavorable factor influencing contractual relations in war-time is the disturbed economic situation. For example, the price structure in war-time is unstable. The demand for certain materials is far in excess of supply, and therefore price control measures must be adopted. Economic readjustment after the war must also be considered.

In peace-time the Government purchases its supplies by inviting competitive bids. The law (Section 3709, Revised Statutes) requires that all purchases and contracts for supplies or services except personnal services, shall be made after advertising, except in public emergencies requiring immediate delivery. In the World War Secretary of War Baker suspended the requirements of competitive bidding shortly after war was declared.

In a major war the purchase of many items by competitive bidding would not be practicable since there would be no real competition between sellers. Initial demand will exceed the normal supply not only of ammunition, guns, and airplanes, but even of shoes, blankets and many other essential items. Therefore the government will be compelled to depart to a great extent from the usual peace-time method of awarding the contract to the lowest responsible bidder. Contracts with allocated facilities will be negotiated although informal competition may be a basis for the negotiations. The time of delivery will be a vital consideration in determining awards.

In peace-time the contractor assumes the entire risk of price fluctuations in materials and labor. If costs decline the contractor makes a larger profit; if costs rise he makes a smaller profit or he may even have to take a loss. But price fluctuations in war-time may be so great that munitions contractors may desire to be insured against losses due to rising prices, especially if the government is determined to prevent large profits. In such a situation the government must assume the risk of rising prices. If the government did not assume that risk, the estimates of the munitions contractors would include a generous allowance for possible increases in the cost of labor material.

Another feature of war-time production of munitions is the fact that many manufacturers will be called upon to manufacture articles with which they are not familiar, for in many cases factories will have to be converted to new uses. Furthermore, war inevitably brings forth new inventions which manufacturers might be reluctant to attempt to produce in quantity without a guarantee against loss. The demand for such a guarantee against loss probably will be emphasized to the extent that the government limits profits.

I have indicated some of the factors that were considered in drafting the new war-time contract forms. These forms were approved on June 14th of this year by The Assistant Secretary of War, on condition that at the end of one year they would be revised. Copies have been distributed to the chiefs of the supply arms and services who in turn will distribute copies to their procurement planning representatives in the field. Full and free criticism of these contract forms has been invited. Through the contact of the field procurement planning officers with industry we hope to have the forms scrutinized by business men and industrial leaders and get the benefit of their criticisms. Unfortunately we have no means of experimenting with these forms in the actual purchase of supplies in peace-time, but by a wide distribution of the forms accompanied by invitations to criticise them we expect to uncover all of their weak points.

There are five contract forms, as follows

1. Contract for Supplies (Fixed Price).

2. Contract for Construction (Fixed Price

3. Adjusted Compensation Contract.

4. Evaluated Fee Construction Contract.

5. Evaluated Fee Construction Sub-Contract.

The Fixed Price Contracts.

The Contract for Supplies and the Contract for Construction are both modifications of the peace-time forms. Both of these contracts are "fixed price" contracts as distinguished from "cost plus" contracts, that is, the contractor agrees to perform the contract for a definite sum. The fixed price Contract for Supplies is the contract form that will ordinarily be used to contract for the manufacture of supplies and equipment if there is a satisfactory basis for determining a fair price. The fixed price Contract for Construction will be used in contracting for small projects when the scope of the work is known, specifications prepared, and where there is small possibility of substantial changes in the cost of labor or material, and where under ordinary peace-time conditions bids would be invited. For the larger construction projects the use of the Evaluated Fee Construction Contract is contemplated. The evaluated fee contract is not a fixed price contract. I will explain each type of contract in detail.

The principal difference between the two fixed price war-time contract forms (the Contract for Supplies and the Contract for Construction) and our similar peace-time forms is the addition of a termination clause and a flexible price clause. The termination clause permits the government to terminate the contract whenever such action is advisable and prescribes definitely the method of settlement. The flexible price clause provides for the adjustment of the contract price in accordance with fluctuations in the costs of labor and material, but requires such adjustments only when the price changes have been ordered by a federal agency. The idea of a flexible price clause and a termination clause in war contracts is not new; they were used extensively during the World War and proved of great value.

The flexible price clause of the new war-time contract forms reads as follows

> "If a Federal Agency appointed for the purpose of controlling the price of labor and/or material causes or approves an increase or decrease in the

price which the contractor is paying for the labor and/or the material for use in the performance of this contract, the Contracting Officer shall promptly determine the increase or decrease in the cost to the contractor of performing this contract that will result from such change and this contract shall, with the approval of the head of the department, be modified accordingly."

The War Department policy is that fixed price contracts will be used in the purchase of supplies and equipment as far as practicable. Under the fixed price contract there is no need for maintaining a staff of government cost accountants at the manufacturer's plant. Under the fixed price type of contract the responsibility for keeping down costs rests entirely with the contractor who will probably be more successful in keeping down his costs than he would be if the government was paying all costs.

The greatest advantage of the fixed price contract for supplies is that it is the customary method of doing business. Unique contract forms may seem sound theoretically but do not always work out well in practice, and this is especially true from the legal viewpoint. Doctor Nathan Isaacs of the Harvard Graduate School of Business Administration, in a recent lecture to the students of the Army Industrial College, expressed the idea thus:

> "The departure from standard ways of doing things is upsetting--upsetting in more ways than you might realize if you haven't thought about it. That is to say, the standard contracts of purchase take care of so many details one never thinks of, that when one uses non-standard methods or forms he is quite likely to find out he has destroyed the whole picture."

However, although the War Department policy is to use the fixed price contract as far as practicable, it is certain there will be some situations where a contractor will not be in a position to bid a fixed price. The article may be an extremely intricate invention that has never been manufactured in quantity. Complete conversion of plants may be required, for example, if an automobile manufacturer were to manufacture airplanes. These are situations where contractors might be more anxious to protect themselves against loss than to make large profits. They may expect that the government will take most of their profits through excess profits taxes in any event, and for that reason might prefer some sort of a cost plus contract. For these and similar situations there has been developed the Adjusted Compensation Contract.

The Adjusted Compensation Contract.

As you know the cost plus percentage contract used during the war was subjected to considerable post-war criticism. It was claimed that it permitted contractors to make enormous profits as compared with the amounts of their investiments. Therefore, since the war the War Department has been developing a contract form that would protect the manufacturer against loss and at the same time permit a reasonable profit for use where some form of a cost plus contract appears essential. This type of contract has been known as the adjusted compensation contract. During the past year the old form of adjusted compensation contract was considerably revised by the War Contract Board which makes a continuing study of proposals for war contract forms and contractual procedure.

The basic principle of the new adjusted compensation contract is that the contractor is reimbursed for the cost of the work and paid a profit which is based primarily on his property investment, that is, the value of the buildings, machinery and facilities owned by the contractor. That valuation determines the basic fee and that fee is 6% per annum of the value of that part of the plant utilized for the contract. (See Par. 4(a), Article II, of contract.) The time element used in determining the basic fee is the period of time in which the contractor agrees to furnish the material. If he finishes the contract in less time than he originally agreed to, he gets the full fee as though he had taken the full estimated time, and in addition he has the use of his plant for the remainder of the time. He might commence another government contract immediately, and is thus furnished an incentive to rapid production.

The adjusted compensation contract also rewards the contractor for keeping down costs under his contract, thus preventing the extravagant use of labor and material. As a reward for economy in carrying out the contract the contractor is paid, in addition to the basic fee, 25% of the difference between the actual cost of the contract and the estimated cost, if the estimated cost exceeds the actual cost, but this additional compensation may not exceed the basic fee. (Par. 4 b, Article II) To sum up, the contractor is paid his costs plus a basic fee based on the value of his plant for an estimated time of performance plus additional compensation for reducing the actual cost below the estimated cost.

Why is the additional compensation for reducing actual costs below the estimated cost limited to the amount of the basic fee? The limitation on the additional compensation was to avoid a repetition of the World War experience with certain of the cost plus contracts, for example, the Liberty engine contracts, where the estimates of cost were almost double the actual costs, resulting in very large profits to the contractors as compared with their actual investments involved. Therefore, in the new adjusted compensation contract the additional compensation made possible by efficient management is limited to the amount of the basic fee which in turn is based on the value of the plant. For example, under the contract a contractor could receive $50,000 as a basic fee and $50,000 additional as additional compensation for reducing costs below the estimated costs.

The adjusted compensation contract is divided into two parts--the contract proper and Exhibit A. The contract proper states the general basis for the contractor's remuneration but also provides that the data upon which the compensation is to be based will be made the subject of a supplemental contract. The supplemental contract is Exhibit A. Included in the contract proper is the enumeration of allowable items of cost for which the contractor is to be reimbursed and stiputations governing the method of payment, inspection of materials, audit of accounts, termination of the contract, the method of settling disputes and other general provisions. The only subjects in the contract proper that require negotiation are the description of the item to be manufactured and the quantities and the delivery schedule. The delivery schedule, that is, the time of performance, is important because it is one of the factors determining the basic fee. As soon as the contract is signed the contractor will proceed with manufacturing operations, he will not await computation of the detailed data in Exhibit A.

After the contract proper has been signed and the contractor has commenced operations, the supplemental agreement, Exhibit A, will be executed. In Exhibit A the government and the contractor agree on the estimated cost of the following items.

1. Direct labor.

2. Direct material.

3. Sub-contracts.

4. Additional buildings, machinery, equipment and facilities required and alterations in existing facilities. (The government is to take title to all additional buildings and other facilities necessary to the contract.)

5. Depreciation.

6. Rehabilitation of the plant to its original condition.

7. Overhead.

The sum of the above items is the "estimated cost" of the contract. The contractor will receive as additional compensation for economical performance of the contract 25% of the savings below the estimated cost.

After the government and the contractor have agreed on the estimated cost of the contract, they must agree on the value of the contractor's investment which in turn determines the contractor's basic fee. This is covered in Article II of Exhibit A and includes the following:

1. The value of the buildings, machinery and facilities owned by the contractor and actually required in or necessarily rendered idle on account of the performance of the principal contract, and

2. The average amount of funds that the contractor will be required to provide for meeting current payments prior to reimbursement by the government.

The sum of these two items is the total amount upon which the contractor's basic fee will be computed on the basis of 6% per annum for the prescribed time of performance of the contract.

It will be recalled that under the old form of adjusted compensation contract the appraisal of the plant was made prior to the signing of the contract. Theoretically the plant appraisal was to be made in time of peace, but this was found to be impracticable and therefore our present form of adjusted compensation contract authorized the contractor to commence operations before the appraisal of his plant. The object of course is to prevent delay in carrying out the contract. The contract provides that every effort will be made to reach an agreement, but if is impossible for the contractor and the government contracting officer to come to an agreement on any item, the Secretary of War will determine the amount of the disputed item and payment will be made on the basis of his determination. If the contractor refuses to accept the decision of the head of the department for any item, the government will make payment on the basis of 75% of the disputed item and the contractor may then sue the government for the additional amount that he contends he should receive. It is contemplated that legislation will be enacted to confer jurisdiction for such suits on the United States District Courts.

The advantage claimed for this form of contract is that the profit allowed has a direct relation to the property investment. Additional profit is permitted if the contractor succeeds in reducing his costs below the estimated cost but this additional profit may not exceed the basic fee based on the value of the plant. Some of the critics of this type of contract claim that there is very little incentive for rapid production, but they overlook the fact that the basic fee is based on the value of the plant for the period of time within which the contractor has agreed to perform the contract. If he completes the contract sooner than was anticipated he is paid the full fee nevertheless.

On April 1, 1935, the ______________________ Company submitted a factory plan for the manufacture of shell forgings and machine shells. The plan included detailed estimates of costs and dates of delivery. The company proposed a form of adjusted compensation contract for machining the shells in which the rate of compensation varied but slightly from our present form. Adapting the company's estimates to our present form we have the following cost of machining 155 MM shells based on costs of labor and material in effect in March, 1935. The deliveries were to be made over a period of 24 months from the time that the company was notified to proceed. The figures for that part of the contract relating to machining the 155 MM shells follows

ARTICLE I, Estimate of Cost.

Labor	$ 6,092,368.00
Material	1,560,210.00
Additional buildings, machinery, equipment and facilities	748,395.00
Depreciation	85,440.00
Rehabilitation	15,000.00
Overhead, including general expense	1,523,092.00
Estimated cost - - - -	$10,024,505.00

ARTICLE II, Compensation.

(A) Fee on Working Capital.

A sum equal to 6% per annum on the working capital required, arrived at by dividing total estimated cost by 24 (months)

Period of contract 24 months.

Total estimated cost	$10,024,505.00	
Average monthly capital required	417,687.70	
6% per annum on $417,687.70 for 2 years		- $ 50,122.40

(B) Fee on Value of Facilities Required.

Old steel car shop and equipment	$673,621.00	
Forge shop and equipment	392,379.00	
	$1,066,000.00	
6% per annum for 2 years		- 127,920.00
Basic fee for contractor (A plus B)---		$178,042.40

The basic fee is the only fee that the contractor receives if the actual cost of the work is the same as the estimated cost. But if the actual cost of the work, for example, should be $100,000 less than the estimated cost the contractor would receive as additional compensation 25% of the difference between actual and the estimated cost ($25,000), making his total fee $203,042.40. On the other hand, should the actual cost exceed the estimated cost by $100,245 (10% of the estimated cost), the basic fee, $178,042.40, would be reduced by 10% ($17,804.24). But in no event will the basic fee be reduced by more than 50%.

Thus the contractor's fee may range from 3% to 12% per year on the value of that part of the plant required under the contract if deliveries are made as scheduled in the contract. The basic fee is definitely based on the prescribed time of performance as stated in the contract, regardless of the actual time of performance. Therefore, the contractor would expedite the work because he would have the complete use of his plant as soon as his contract is completed regardless of the "prescribed time of performance" stipulated in the contract.

The Evaluation Fee Construction Contract.

The evaluated fee construction contract is a modification of the World War cantonment construction contract. There was considerable post-war criticism of this contract but it is significant that during the war none of the basic principles of the contract were changed. From eighty to ninety per cent of thw World War building program was done under the cost plus contract. The principal difference between the World War cantonment construction contract and the new evaluated fee construction contract is a new method for determining the fee. The fee is variable, depending upon the manner in which the contract is performed based on the speed of performance and the quality and economy of performance. The determination of the fee within certain limits is made by the Chief of Branch under whose supervision the work is performed based upon the findings and recommendations of a board appointed by him for that purpose.

The maximum and minimum fees are as follows:

Cost of Work (As per Article II)	Maximum Fee (Per Cent of Cost of work)	Minimum Fee (Per Cent of Cost of work)
100,000 or under	6.0	3.6
500,000	5.5	3.3
1,500,000	5.0	3.0
2,500,000	4.5	2.7
3,500,000	4.0	2.4
5,000,000	3.5	2.1
7,000,000	3.0	1.8
10,000,000	2.5	1.5
20,000,000	2.0	1.2
30,000,000	1.5	1.0

341

The purpose of the Evaluated Fee Construction Subcontract is to place the contractor in the same regard to his subcontracts as the government occupies in the principal contract and to place the subcontractor in the same position in regard to his subcontract that the contractor occupies in the principal contract. It simply extends the principles of the evaluated fee contract to all of the subcontracts.

Summary.

To sum up, in the legal and contract phases of procurement planning the past year has been an eventful one. In the legislative phase congressional committees have drafted a bill that is a landmark in the history of planning for war-time mobilization of the nation's economic resources. In the contractual phase, war-time contract forms have been definitely approved by The Assistant Secretary of War.

341

DISCUSSION FOLLOWING LECTURE BY CAPTAIN CHEEVER

"EMERGENCY LEGISLATION - WAR-TIME CONTRACTS"
January 11, 1936.

Q - The right of commandeering - that was given us under the National Defense Act?

A - Yes. We have ample authority to issue compulsory orders in war time or when war is imminent, and to commandeer in the event producers refuse to comply with such orders.

Q.- What more does Bill H.R. 5529 give us?

A - It gives us authority to take over the use of any plant, without going through the formality of issuing a compulsory order and having it refused; and all other powers considered necessary such as price fixing, priorities, licensing and general regulation of industry.

Q - In these evaluated adjusted compensation contracts, Doctor Sanders spoke yesterday suggesting the use of the phrase "investment less depreciation" instead of the word "value". What do you think of that?

A - I think that is an excellent suggestion. He said we should use "cost of investment" instead of "value" as a less debatable term to be used in determining the basic fee.

Q - Don't you think there would then arise questions as to the adequacy of depreciation?

A - There would be these questions but I think they would be more easily settled than by using the term value.

Q - With reference to these contracts - particularly the evaluated fee contract where you have a contract effective without a definite percentage of cost, has the propriety of that theory been passed upon by the Comptroller General?

A - No. It has by our legal authority. There is no question about the legality. In the first place, in the contract proper the parties agree to make a supplemental agreement later covering the price, estimated cost, etc. In the second place, the contract is placed under Section 120 of the National Defense Act permitting the price to be determined later.

Q - I don't see how you can expect to use the fixed price contract in war. In the last war (and it will happen in any war) the price of labor and material rose very rapidly and contractors who undertook fixed price contracts found themselves in a bad situation. It does not seem to me it is the proper kind of contract.

A - When we speak of the contract that should be used and the contractual procedure that will be used we have in mind only one item or one class of item. Some items are easy to procure either in war or in peace. Some one mentioned a can of tomatoes - a simple item and easy to procure. Of course, when you come to airplanes and guns it is a different situation. In connection with rising prices, our fixed price contract contains a clause that makes adjustment for rising prices, so although we usually say it is a fixed price contract there is a clause which protects the contractor against rising prices of either labor or materials.

Q - Have you an estimate as to the number of adjusted compensation contracts that would be used? I asked that in connection with a question that arose yesterday in connection with the need for

Q - In connection with additional buildings and machinery - would the Government make payment for those immediately upon installing or at the end of the period remove them? Do you propose to pay interest on that money on the possibility that a part of the $748,000 would be paid in the first few months and the Government would immediately pay for it upon completion of the installation. Would the interest be paid for two years on that?

A - That is a good question and it is a matter that would be adjusted at the time.

Q - I understand the Chiefs of the Army and Navy procurement services were furnished these forms with requests for criticism. What industrial organizations were asked for advice?

A - The forms have been distributed by the chiefs of branches to all of the district procurement planning offices and they in turn have called in industrialists in their districts asking for criticisms. They have been given seven or eight months in which to do this. Already we have received letters from industrialists which the district officers have forwarded to the War Department making suggestions and criticisms.

Q - Have such organizations as the U.S. Chamber of Commerce been asked for advice?

A - Not formally by The Assistant Secretary's Office. The district offices may ask whom they please.

Q - In connection with the adjusted compensation contract - here you have a contract in which all that is talked about is $748,000, but the Government is going to pay somebody $10,000,000. How are you going to check that cost; a 5% error would be about $500,000. The contractor wants to get the cost as high as possible.

A - That will be checked by accountants with accounting manuals as guides. As Doctor Sanders said yesterday, there will be differences of opinion as to correct allocation of overhead and other matters, but as a result of experience it should be possible to arrive at some reasonable adjustment.

Q - You have to keep track of and check every figure of all that expenditure of $6,000,000 for labor. It has to be done as you go along?

A - Yes.

Q - In connection with that fixed price contract which you are going to have in these 10,000 facilities - how is the price to be determined? Who knows enough to say what it is going to be? Are you going to take the contractor's word?

A - In the first place we don't think it is considered necessary to have negotiated contracts for all of these 10,000 facilities. The fact that they are allocated does not restrict us from having informal competition between those who manufacture the same item. If the article is one that is controlled by a few manufacturers, say three or four or even a half dozen, you will get them together and negotiate the price. There will be people in the War Department who will have a good idea of what should be charged and an agreement will have to be made. You cannot have competitive bidding for some articles of Ordnance that are entirely inadequate in supply.

There should be an agreement upon prices - unless some other technique is devised. As a last resort, of course, the Government could issue a compulsory order to those who will not cooperate.

Q - Continuing that phase of the discussion apropos Major Rogers' remark, in the informal bidding attendant upon negotiation in the early stages of production of strictly commercial items, is there any limitation on the amount of money involved in the contract, such as we have under peace-time laws? Should the compensation be confined within that sphere?

A - I don't believe you could lay down any general rule. It depends upon the item and upon the industry. If it is a textile industry with thousands of plants scattered all over the country you may have a different rule than if it were some article of Ordnance where the manufacture is controlled by one or two or three concerns. If these two or three concerns are located in different districts it seems to me they should be contacted from central points. If they are widely scattered as in the textile industry it may be advisable to confine the negotiation within districts. In my opinion, it depends upon the item.

Q - I would like to bring up the question of the time element from M day to such time as the new system can get under way - the same general question that General Gibson mentioned in his M day bridge plan. Assuming the extreme case where the war situation developed suddenly - M day arrives without any chance of preparation - we have a situation where the peace-time contracting organization is restricted to one method of purchase - competitive bidding. We have under the war plan the

342

opposite extreme - an entirely different form of contract. What thought is being given by the Planning Branch to the transition period between leaving our peace-time set-up and going over into such time as this system can be made to work - granting that this system is perfectly workable? Isn't there a possibility of great confusion in dropping one organization and taking up an entirely new one?

A - As General Gibson indicated, the Quartermaster Corps is making plans to cover contractual procedure during the transition period immediately following M day. The different branches have different plans depending on the item to be procured. As I understand it, the Air Corps plans to let all contracts from Wright Field immediately and then decentralize their procurement organization into six procurement districts for administration and supervision of the contracts and the negotiation of further contracts.

Colonel Scowden: In that connection we have Committee No. 10, Corps Area Procurement and Supply, which will dwell on that at some length.

Q - In connection with Title III of this Act, I understand the War Department is interested in War Resources Control and it could be put into effect prior to the declaration of hostilities. What I wonder is, are we to understand that anybody in the War Department thinks that Congress would take any such action? To do so would be considered as an act precipitating such hostilities and if Congress were not in session it would not be called into session just to declare war. Has it been considered that the President might declare such a national emergency? Would it not be the better method?

A - I don't know what the committee had in mind when it made that distinction between Title III and the others.

Simply because just prior to the World War the President was attempting to maintain strict neutrality does not indicate that the same situation would again prevail. It may be that another President would prefer to indicate some show of strength even through a period of strained relations. What Congress had in mind I don't know but so far as the President declaring a grave emergency due to the imminence of war without the authority of Congress I think that would be rather extreme. I think Congress would prefer to make the declaration and the President would prefer to have it so. After all, Congress directly represents the people and the people, so far as they can, prefer to have control of the war making power in the hands of their representatives.

Q - If that Board of Officers which determines whether the maximum or minimum fee will be paid does not meet until after the contract is completed, what provision is made for partial payment?

A - Partial payments are made on the cost as the contract proceeds - weekly or monthly. After all, the fee is only a small percentage of the cost. The contractor is reimbursed for the cost as he goes along, and is paid the fee after the contract is completed.

Q - Under an evaluated fee construction contract it is necessary to make a partial payment every month whether the contract is completed or not. Would the Board of Officers meet that payment?

A - Not until the contract is completed, so far as the fee is concerned. He is reimbursed for costs as the contract proceeds.

Q - Who determines what the monthly partial payment is?

A - The contracting officer.

Q - That Board of Officers determines that?

A - No; the Board of Officers only determines whether the contractor receives the minimum or maximum profit. The contractor gets a full return on the cost monthly.

Q - Who determines the cost every month?

A - There will be Government accountants there and they certify vouchers for payment to the Finance Officer. The contractor pays for labor and material and the Government Finance Officer pays the contractor.

Q - I would like further elaboration on the first question by Commander Allen. It seems to me that in this adjusted compensation contract you are relying upon increasing the profit of the contractor to stimulate him to earlier deliveries. Under Title 1 of this proposed Act it was my understanding that war-time profits of the corporations will be limited to 4½%. What incentive do you give to the contractor to reduce his time by giving him 6% or 12% if you promptly take it away from him again?

A - The basic features of the Adjusted Compensation Contract were adopted before Title 1 of this bill was ever thought of and the War Department did not make any suggestions as to the rate of taxation or pass any opinion on it. The bill may be passed in a different form.

Q - If it should pass in its present form then the contract would have no real merit.

Colonel Harris: A corporation may have a dozen types of contract - some civilian, some Government. The money they make on the Government may bridge them over. In my mind a corporation has no right to make more than 4.7%. It is taxed on the yearly annual operation.

This discussion this morning has taken in the whole range of Planning Branch activities. Major Rogers asked how you arrived at costs. I don't think that question has been clearly answered and it is a confusing question. Suppose the article is shoes; the Quartermaster purchases a million pairs of shoes at, say, \$2.40. The fixed price contract protects the contractor and he should not expect to get any more. There are some defects that have developed already in the form. I would like to call your attention again to the blackboard. On a contract of \$10,000,000 and a saving of \$1,000,000 the contractor would be entitled to 25% of that figure if it did not exceed the basic fee. In other words, that figure of 25% is too large because in saving 10% he will be able to double his original fee. By saving probably 7% on the total cost he could double his fee. I think it is perfectly clear that 25% is too large.

There are going to be two types of contract necessary; one is the straight cost plus. Suppose we want a laboratory to do some research work for us; there is only one way to pay the expenses and a fee - that is by the cost plus contract. On one extreme we have the fixed price and the adjusted compensation on the other. They are far apart and something like the Pittsburgh contract is going to fill the gap between. As to whether or not labor and material changes would jeopardize the contract in war - I think the clauses safeguard those features. I don't want the class to feel that in our association and development of this bill we have not given consideration to those provisions. We have.

Q - What I was trying to bring out was this. You are not dealing with a military organization, you are dealing with a civilian organization and you have got to give an incentive to private organizations in time of war. I think you are building up a situation in which you are not giving a sufficient amount of incentive.

Colonel Harris:- There is a lot of merit in what you say.

Colonel Jordan: In connection with Colonel

question I want to read this from the form:

Article XI states that disputes concerning questions of fact shall be decided by the contracting officer subject to written appeal by the contractor within 30 days to the head of the department concerned, whose decision shall be final. I think that covers that particular point about fixed price contracts.

Colonel Harris. Some one asked what proportion of cost plus contracts were made. Cost plus contracts were used in the war more than they should have been. In the Ordnance Department the amount of money expended on cost plus contracts was only 25% of the total amount spent by the Department. In connection with the building of plants, 75% of the material which was purchased by the Ordnance Department was by the fixed price contract.

Q - I would like to ask if the speaker does not think he is a little optimistic in view of past experiences relative to competition between allocated facilities? It seems to me that allocations will ipso facto fix the price.

Colonel Harris: In the first place, allocations and competition cannot exist at the same time except in special circumstances, because they are diametrically different philosophies of procurement. Suppose the Quartermaster Corps were allocated 80% of the shoe industry of this country. In this particular case there is nothing to prevent them from having informal competition within that 80% since the 80% are allocated to the Quartermaster - one procurement agency. I don't think this situation ought to be considered inflexible. If the Quartermaster had twenty plants allocated and making shoes he could get competition within these twenty, as long as he kept a record of what he was doing and did not lap over into the Navy's allocated plants.

If the Government is not capable of knowing what it is doing it is going to get gipped anyway. There ought not to be any doubt as to the price to be paid for shoes. If they want to gang up - to use a slang expression - what is to prevent the Quartermaster from knowing they are ganging up? You can place a compulsory order and tell the man he is going to do it and he can sue after the war if he wants. The Government is going to exert more power in war.

Q - Has the Government made provision to take over the plant also and operate it in case they are not willing to give you a reasonable price?

Colonel Harris: That authority exists. The effect of commandeering is like the policeman's club - always in sight but little used.

The threat is there. The power of public opinion in war is a tremendous power. I was told of an occasion yesterday. In the city of Detroit a very prominent business man in the last war ignored the gasolineless Sundays and took his wife and daughter out for a drive. Not only was that man expelled from his club but public opinion in Detroit ran him out of the city. Public opinion is going to be a strong factor and will have a determined effect on the people who want to do what is right.

Q - Do you think there will be any more ganging up in time of war than there is in peace-time?

A - I think in war the psychology changes. You have public spirit and cooperation and I think much of the impression we have of conditions in the World War are the result of investigations after the war. During the war there was public spirit and cooperation.

Q - I have gone into the bill and have noticed the small percentage figures as profits and depreciation and I wonder if you have not lost sight of the fact that we have not fully taken into consideration the fact that a man makes a certain amount on his business and the Government is going to take away a big share of it. The Government is going to take more than it did in the last war and I wonder if that should not be taken into consideration. We have not considered the fact that he does not get all we allow him.

A - The question is, what is a fair margin? In these contracts the contractor assumes no risk at all. Under these contracts these profits are fair margins with the Government assuming all of the risk.

Q - When you speak of fair margins I assume it is thought that the amount the contractor makes is fair even considering that the Government will take some of it in taxes?

A - Yes.

Q - We have heard a lot of discussion about the building of arsenals and laboratories. Do you think Section 120 of the National Defense Act gives authority for compulsory orders to build laboratories and arsenals?

Colonel Harris: That question was raised before the Nye Committee, in connection with the Du Pont Engineering Company, whether Section 120 could not have been used to commandeer the Engineering Company and force them to build Old Hickory. There were lawyers present and they decided both ways. That is the answer.

Q - I understand that this provision in Section 3 - under a compulsory order is the contractor if not satisfied it allows him to sue at the end of the war. Must he wait until the war is over?

A - Yes.

Q - It is entirely possible that the Government might be wrong or that the war might last ten years.

A - This Nye bill provides that those who are not satisfied with the amount the Government decides is just compensation will wait until after the war. In the adjusted compensation contract it does not say "after the war".

Q - Do you think that will stand as constitutional?

A - I think so.

Colonel Jordan: I think the questions and the various propositions that have been brought out in this conference indicate the intense interest the College has in contractual procedure and I want to thank Captain Cheever and Colonel Harris for the time they have given us on this problem. There is no question in the world but that these contract forms we have drawn up will be revised. The speaker yesterday brought out defects in one and, as Captain Cheever says, it is going to be considered. I hope the class and the committee studying this problem will bear in mind what we have heard here this morning and give the Planning Branch the benefit of their studies on this subject.