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WAR CONTRACTS AND PROCEDURE

by

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This morning we shall discuss the legal phases of war procurement -- how industrial plans are to be given contractual relationship.

War-time contracts have several considerations first, the economic and industrial problems attendant upon war-time procurement, second, the permanent statutory limitations of the contractual powers of Government agents, third, the probable temporary legislation which may be expected, and fourth, the extensive use by the Government, in war time, of the right of eminent domain. Developments since the war have brought forth another prime consideration --unreasonable profits to industry

In view of the fact the War Department has concurred in the legislative opinion that industry in a future war should receive only a fair profit, war contracts are built upon this premise. Various theories of war profits tax have been advanced. It will be remembered that the War Policies Commission recommended a tax of 95% of war profit above the previous three year average. The House at the last session of Congress passed a bill (H.R. 5529 introduced by Mr. McSwain) carrying in general terms a war excess profit tax of 100 per cent. The Nye Committee reported an amendment to this bill taxing industry all war profit over 4.7% of the adjusted declared value of its capital stock, and a 100% of all personal incomes over \$10,000. The Senate Finance Committee substituted and reported an amendment carrying an undistributed profit tax of 77% and a rather high rate on personal incomes with low exemptions. The interest of the War Department in war tax measures is appropriately expressed in the Senate Finance Committee report on this bill

"A tax law devised to yield revenue sufficient to run a war, should, in addition, be constructed so as not to hinder the production of war materials nor curb the incentive for continuous economic activity. More than on any other occasion, in a time of war the marginal producer is as necessary as the low-cost large-scale producer. His productive activities must therefore be fostered and maintained."

Title I (Tax provision) of H. R. 5529 as reported to the Senate just before Congress adjourned its last session was rather hurriedly considered and adopted. Certain features of the bill are objectionable from a War Department viewpoint. It is hoped that more mature consideration may be given these tax provisions in the future.

Industry as a whole may now be said to appreciate that another war will bring only a normal profit return, and that cooperation will be extended on that basis with the hope and trust that producers will be protected against loss and ruin.

The problem of war-time contracts is in reality one of developing the tools of efficient ~~governmental~~ business procedure under war conditions. The task as we see it is to avoid the contractual pitfalls of the World War, and to fit into present procurement planning the necessary contractual relationships to affect a war production.

In contrast to the adopted war contracts of 1917 and 1918, this phase of planning has advanced in a considerable degree. Uniform contractual forms for War Department current procurement have been adopted for the use of all supply arms and services. The use of these same

fixed-price forms with necessary emergency clauses will avoid a sudden change to meet war conditions. Likewise the forms at present in use for informal contracts and purchase orders will also be available.

Without criticising the general contracting procedure during the World War which had as a whole gratifying results, a few of the principal difficulties in carrying out World War contracts, other than the voluminous task of interpreting the various four hundred forms used by the different supply arms and services, were first, the legal and financial difficulties encountered in fixed-price contracts where no allowance was made in the contracts for future variations in the price the contractor was forced to pay for materials and labor, second, the legal difficulties which resulted from having no termination clause in war contracts, and lastly, the unauthorized signing of contracts on the part of the Government by appointed deputies who signed the name of the contracting officer named in the body of the contract and then signed their own name thereafter. Contracts signed in this manner were generally called proxy-signed contracts. Strange as it may seem, of the 27,000 contracts of the War Department in existence on November 12, 1918, 7,500 had not been executed in the prescribed manner. A test case was taken to the Supreme Court of the United States (N.Y. & Porto Rico S.S. Co. vs. U.S. 239 U.S. 88) and the court held that such a contract could not be enforced by the Contractor against the United States. The Secretary of War could not, therefore, pay out anything under it except for goods had and received or for services rendered to and accepted by the United States.

This however would not do justice, for in almost every contract, there were goods in process, overhead expenses, and other items which would not be covered nor reimbursed by merely taking over the finished product at the contract price. The Secretary of War could not amend these contracts as he could in the case of agreements properly signed for it is a fundamental principle of law that an amendment is itself a new contract, and that no contract may be made without a consideration. That is, in order to make a valid amendment, something of value must pass to the United States. Now, as the informal contract was not enforceable against the United States, no amendment to the contract was legally possible.

It became obvious that in order to do justice to meet the situation action by Congress was required. Some months later the so-called Dent Act was passed. Under this act the contractor was obliged to file his claim with the War Department and Boards of Contract Adjustment came into being which found themselves flooded with work.

All this time the contractor was put to additional expense in presenting his claim, was deprived of his money and in most instances interest thereon through no or little fault of his own, and his war patriotism went to a low ebb. And Army so-called red tape gets the blame.

The present adopted war contract forms have been the subject of much study by the Planning Branch, and by the War Contract Board which is a permanent Board within the War Department, the personnel being made up from officers of the Planning Branch and from the various

supply arms and services. Five contract forms have been tentatively approved by the Assistant Secretary of War, and will be briefly discussed this morning.

1. Contract for Supplies (Fixed Price)
2. Contract for Construction (Fixed Price)
3. Evaluated Fee Construction Contract
4. Evaluated Fee Construction Sub-Contract
5. Adjusted Compensation Contract

The forms now adopted do not carry the name of the contracting officer in the body of the contract. The term used in the preamble covering this part of the agreement reads that the Government is "represented by the Contracting Officer executing this contract "

This designation is legally sufficient and will avoid the difficulties encountered with the so-called proxy-signed World War contracts. Termination clauses are now included in all war contract forms.

The fixed price supply and construction contracts now contain a flexible price clause relating to material and labor. There is no doubt that the inclusion of such a provision will encourage formal and informal competition and contract negotiation for a fixed price, for if the Contractor is assured he will be compensated for radical price rises, he will feel more justified in making a set price offer.

The War Contract Board has just made a recommendation to the Assistant Secretary changing in important detail this flexible price clause of the fixed price supply and construction contracts. The article before the recommended change read

"ARTICLE - CHANGES IN PRICES OF LABOR OR MATERIAL

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".

There now has been inserted after the word "controlling" the words "and/or adjusting". The term controlling alone was too restrictive. If a controlling agency of prices or a controlling agency for wages were not set up, or were concerned with broader questions of price and wage control than those concerning a particular contract, then this important provision would become non-operative. As changes, the adjusting agency may be set up in the War Department itself, in the War Resources Administration or elsewhere. This provision then becomes a feasible one for war developments.

Another recommended change in this same article requires consultation between the Contracting Officer and the Contractor before submission of a price change to the head of department.

The fixed price forms for the purchase of supplies and construction are to be used where procurement may be based on competition or

negotiation. In other words where peace-time procurement has laid a basis for war-time expansion and a satisfactory determination of a fair price can be had--then the fixed price forms may be used. A thought in this connection is that the Quartermaster General now plans to let cantonment construction contracts on a fixed price basis after formal or informal competition. This illustrates one of the developments in procurement planning since the World War, when all such contracts were let on a cost price basis. It will be remembered in connection with war procurement, that the peace-time compulsion of formal competitive bidding set out in R.S. 3709 is not a directive to war-time contract procedure, but may be short cut in the discretion of the Secretary of War.

The greatest advantage of the fixed price contract is that it is the customary method of doing business. Other forms may seem sound theoretically but do not always work out well in practice.

In the event a construction project is not one subject to a fixed price contract, then the use of what has been approved as the Evaluated Fee Construction Contract is contemplated. Expansion of existing chemical plants & air-plane factories, and the building of plants and additions thereto necessary in ordnance material production will probably come within this category

The evaluated fee construction contracts are in general modeled after the construction contracts used during the latter part of the war and found in general to be satisfactory. The principal change from the old form is the inclusion of a variable fee between certain

percentage limitations, the adjustment to be based upon efficiency in performance by the Contractor, viz., speed of performance, quality of manufacture and economy of performance. The maximum and minimum fees are pictured on the chart. The Evaluated Fee Construction Sub-Contract extends the principles of Evaluated Fee Contract to all of the sub-contractors.

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 or one that is satisfactory to the Government. 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.

Time does not permit a detailed analysis of this contract form. I may say in brief that this contract proposes to reimburse the contractor for the cost of the work and pay a profit which is based primarily on the property investment, that is, the value of the buildings, machinery and facilities utilized under the contract. Additional profit may be gained by a saving between the estimated and actual cost of

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production, the actual payment to be in general 25% of the difference involved. In addition the contractor receives 6% on his working capital. The details of this contract will undoubtedly be presented to you by your Committee on War Contract Procedure.

The Adjusted Compensation form represents considerable thought and consideration by various experts. It was subjected to certain criticism by the Nye Committee and has since been changed and improved in some details. Its principal fault lies in the fact that we admit that the form is to be used for the manufacture of articles about which there is little information as to cost of production and the first agreement necessary under the contract is an estimate of cost of labor and material and overhead necessary to secure this same production. The contractor is obviously going to get these figures as high as he can for his own protection, and as has already been noted, a part of his net fee is based on the difference between the estimated and actual cost.

The so-called Pittsburgh unit profit form is subject to the same objection and the estimate in this plan must necessarily be in greater detail, as it must be reduced to an estimate of unit cost. Though the Pittsburgh form has not been approved by the War Department Board, an exhaustive study of its features has been made by various individuals and boards and there are advocates favoring its adoption. As a matter of fact there is little difference between the Pittsburgh form and the Liberty Motor Bogey contract forms of the World War, and the War Department certainly had pronounced difficulties with the latter.

The suggestion has been made by the promoters of this form that in cases where no reliable figures are available for guidance in determining the estimated average cost of the work involved, the lapsed time of the contract may be limited to 4 or 6 months, so that ample opportunity may be given to secure reliable cost data under actual producing conditions, whereby the contract may be renewed at the end of its initial period on a more accurate basis. While it is true that this is one control which may be exercised in both the Adjusted Compensation and the Pittsburgh forms, is such a plan conducive to the desired maximum production? The probabilities are that a new contract will decrease the profit of the contractor. Will he be willing to continue the contract on a reduced basis? Will he carry along materials for continued production or will he wait for the next contract before making additional purchase investments? Will the contractor care to make financial arrangements for a series of short term contracts, any of which may be terminated at the option of the Government? These questions to me answer themselves. Our office recently took the liberty of requesting the unofficial opinion of an expert in the Internal Revenue Bureau on both the Adjusted Compensation and the Pittsburgh form contracts, and in his opinion both contracts had objectionable features and of the two, the Pittsburgh plan was the least acceptable.

Thus it will be seen that the problem of adjusting a war time contract to meet this particular situation is heavily involved. A straight cost plus contract could never be defended since our World War experience with this form. Contracts based upon estimated cost

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of production have the objectionable features heretofore discussed.

The Legal Section has just completed a draft of a supply contract to bridge the field between the Fixed Price Contract and the Adjusted Compensation Contract. Representatives of the Treasury Department, the Internal Revenue Bureau, and various civilian agencies have been consulted in reference to its promulgation. This draft of contract was last week given temporary approval by the War Contract Board and will now be submitted to interested branches for consideration.

The objective has been to draw a contract as simple as possible under the circumstances, to avoid the necessity of basing the price on an estimated cost of production, and to divide the profit into elements which may be controlled to fit a particular contractual situation.

I believe this tentatively approved draft has been distributed to the class. The copy that you have does not contain the few minor changes made by the War Contract Board. By the preamble it will be noted that the contract is placed as a compulsory order under section 120 of the National Defense Act. The primary purpose of this action is to give the contract legal preference over existing civilian contracts which the contractor may have, and to legally relieve the contractor from the responsibilities of complying therewith.

Article I (p.3) contains a statement of the work--what is to be made, how it is to be made, and the when and where of delivery. Article II (p.4) sets out the elements of consideration. Article III (p.4) provides for reimbursement to the contractor for all direct labor and

materials and proper proportion of overhead exclusive of depreciation and/or amortization. Article IV (p.8) provides for a payment of a monthly rental of the plant or part thereof to be used for Government manufacture. It will be noted that under the provisions of sub-paragraph "a" the contractor shall proceed immediately with the performance of the work, and that the rental feature is made as a supplemental agreement to be consummated within two months from the date of the principal contract.

In connection with this rental feature of the contract civilian advice and assistance has been sought. It will be appreciated that similar questions are arising daily in the business world. Large fire insurance companies are now writing an insurance contract known as a "Use and Occupancy Policy", which provides for a payment to an industrial organization for time lost through the closing of a factory for various reasons. The rental to be paid under a Government contract such as here discussed should, it seems, be based upon what is commercially known as the sound value of the plant, viz., the cost of replacement, new, as of the date of the appraisal, less a reasonable depreciation however caused. This definition has been set up on page 26. This is the prevailing value of his investment. All fire insurance companies are today basing the amount of coverage permitted under a policy on this determined value of a factory. When fire losses occur the payment is made on this ~~same~~ basis and in this instance the physical characteristics of the property may be gone but adjustments are made regardless.

In recent years many industrial plants have been refinanced all requiring the same appraisal as is called for under this section of the contract. What I am trying to bring out is that the problem of an equitable rental based upon sound value will not be an entirely new and foreign consideration in time of war.

Reputable national organizations are now actively accomplishing such appraisals for large fire insurance companies, investment companies and private individuals and companies. At the present time the American Appraisal Company which is a large national organization is cooperating in the consideration of this proposed contract. The Fire Companies' Adjustment Bureau, Inc., an adjustment company of national repute is also assisting. McCrossin and Company, Engineers, of New York City have also given valuable suggestions. From research made to date it seems fair to assume that in time of war, civilian facilities as these could be used to advantage by the Government, or individual experts from them be called into the Government service and form a division in the contract sections of the supply arms and services or at the procurement districts concerned with such contracts (principally the Ordnance and Air Corps). All appraisals could be made by these units. The procedure followed by the large appraisal companies today would probably be found satisfactory. The field men of the organization make the physical inventory of the plant. Experts on real estate make their report on the buildings and grounds, the experts on different classes of machinery and equipment make their individual reports. The actual appraisal is

done at the group headquarters and is based on these several reports. These figures could then be coordinated with the estimates submitted by the contractor. In this connection it is of interest to learn that these civilian services mentioned place a time limit of two weeks for the appropriate appraisal of such plants as the Glenn Martin Plant at Baltimore or the Hudson Motor Car Company of Detroit. It will be recalled that a time limit of two months has been specified in the proposed contract form. In case of disagreement the contract outlines the procedure to be followed.

Another basis of investment determination is suggested by the Valuation Division of the Bureau of Internal Revenue. That is to pay the contractor a rental based upon the cost less depreciation already taken for tax purposes. In 1934, the Treasury Department through the Commissioner of Internal Revenue issued a directive on cost data to be filed with the Bureau which was recapitulated on July 10th of last year. I quote in part from this directive

"***** taxpayers claiming deductions from gross income for depreciation must furnish full and complete information regarding (1) the cost or other basis of assets for which depreciation is claimed, (2) the age, condition and remaining useful life of the assets, (3) the portion of the cost or other basis which has been recovered through depreciation allowances for prior taxable years and (4) such other information as may be required to establish the correctness of the deduction claimed or to determine the amount of the deduction properly allowable."

As a result of this order every industrial plant of any size will have on file in the Internal Revenue Bureau their own statements to the cost valuation of their factory and these statements are kept

up-to-date during each taxable year.

I have seen some of these schedules already filed. The cost inventories are filed by groups - realstate, heavy machines, moveable tools, etc. The epreciation schedules are inserted. Costs of machinery discarded or scrapped are shown in red. The burden of proof is on the company to make a correct compilation and taxes are paid accordingly. Reports of large companies are divided into plants and various facilities. The United States Steel Corporation recently filed its schedule which is composed of many volumes. The cost of this compilation was estimated to be at least \$500,000. If, in the contract under discussion, these figures were used as a basis of rental and the records of the Internal Revenue Bureau were complete and up-to-date, the problem of compiling Exhibit A of the contract would be comparatively simple. These Internal Revenue schedules are all confidential at this time, but in time of war would be available for contractual purposes. Research to date, however, indicates that a rental based on sound value is more equitable to the contractor and that industry would prefer such a basis. Whether the sound value or original cost be used as a basis of rental, these records will be of material assistance in arriving at the objective of a fair monthly rental, and of particular assistance in connection with depreciation. A percentage of 4.8% would appear to be a fair war time return to the contractor on his investment and this rate has been adopted in Exhibit A of the contract.

Depreciation to be allowed under the operation of the contract

can be determined at the same time the estimated value of the facility is ascertained, by extending the rate of depreciation in accordance with the shifts involved and thus made a part of the monthly rental as indicated on pages 3 and 4 of Exhibit A.

A very important point recently ascertained from the Bureau of Internal Revenue in connection with contractual allowances for depreciation, is the fact that regardless of what allowances may be made in a contract, the income tax laws require that the payment involved be included in the gross income, and the actual deductions to be permitted are determined by the Bureau of Internal Revenue. If determined by that Bureau to be less than the amount paid under the contract, the balance is taxed as profit.

Having now separated by contract, compensation for the use of the plant, from production operation, the inspiration toward the efficient operation of the plant and the promotion of efficient production by the owner is provided for in Article V (p.9). By this provision a graduated fee (p.11) is paid the Contractor in addition to his rental, based upon a percentage of the actual cost of the work performed, all of these direct costs being paid by the Government. The Contractor then is assuming no risk in connection with his manufacture, which is a reasonable provision under the attendant circumstances of production. This payment is then, in a commercial sense, compensation for management and is based on a maximum and minimum sliding scale dependent upon speed in performance, quality of work performed, and low cost consistent with speed and quality of production rendered to the Government. As the total cost of work (exclusive of rental) increases the

percentages governing the fee decrease. This same principle of compensation has already been approved in the Evaluated Fee Construction Contract. In other words the contractor will not be tempted to pile up his costs in order to receive a resultant larger fee.

Article VI (p.13) provides for changes and Article X (p.15) gives the Government the option of acquiring additional articles under the existing terms of the contract, a mutual contractual advantage in the event the performance under the contract has been found to be satisfactory and both parties are in favor of continuance.

Article XVI (p.24) of the contract advances a new principle of compensation for rehabilitation. How much sounder is the doctrine that reimbursement for rehabilitation be made after the services of the contractor are no longer needed and the rehabilitation to be done is actually at hand, than to guess and attempt to visualize this indemnity to the contractor at the initiation of, or during the early stages of, the contract! Thus another troublesome feature of the Adjusted Compensation Contract will be put on a more businesslike basis.

What we have attempted in this new contract is to take what we consider the best elements of the Adjusted Compensation Contract and the Evaluated Fee Construction Contract and apply them in principal to a supply contract for use when the particular circumstances of manufacture are not subject to a fixed price contract. Eight different estimates are necessary under the Adjusted Compensation Contract--cost of material, cost of labor, cost of overhead, cost of new construction (if any necessary), time of performance, rehabilitation, value of facilities

and depreciation. The new contract reduces the estimates necessary to the last two--value of facilities and depreciation, and these two may be adjusted, we believe, in accordance with procedure and practice more or less recognized in, and familiar to, the business world today.

CONTRACT PROCEDURE

The planning for war-time contractual procedure is a responsibility of the chiefs of the supply arms and services under the supervision of the Assistant Secretary of War. The procedure contemplated must necessarily be flexible, depending directly on the strength of the mobilization. Furthermore, the procedure in placing contracts may vary widely in the procurement of various classifications of material. For example contractual procedure for the manufacture of certain commercial articles for which the nation's existing productive capacity is adequate may be procured in war by peace-time methods. This does not mean that in time of war, all the formal peace-time procedure will be followed, but the principle of competitive bidding will be possible to the extent of shortening the time for receiving bids, limiting bids to the available producers without disrupting other allocations, and securing these bids by telephone or personal attendance around a conference table at a district headquarters. Bids may thus be awarded to the one, two or three lowest bidders, and in this way prices may be subject to considerable control.

Where the purchase of non-commercial items is involved or the whole producing capacity is necessary to comply with requirements--then competition will be impossible and contracts must be negotiated as to fixed price, or one of the computed profit forms of contract heretofore mentioned will be the alternative.

WAR EMERGENCY LEGISLATION

War emergency legislation relating to industrial mobilization received more attention during the last Congress than at any time since the war. In April 12, 1934, a Special Committee on Investigation of the Munitions Industry (known as the Nye Committee) was authorized by the Senate and directed among other things, to review the findings of the War Policies Commission made in its report of 1932. Pursuant to this Senate Resolution public hearings were held in September and December of 1934 and throughout the first 4 months of 1935. As a result our 1933 Industrial Mobilization Plan became a subject of study, comment and criticism, and no small amount of credit is due our present Director of the Planning Branch for his efficient and effective explanation of the plan and its defense before the Committee where such defense was found necessary.

It will be remembered that the War Policies Commission recommended in part that "in order to eliminate all doubt concerning the extent of the power of the Congress to prevent profiteering and to stabilize prices in time of war, that a proposed constitutional amendment clearly defining such power be submitted by the Congress to the States." Since 1932, further legal study has been made of this subject, and the United States Supreme Court has since that date announced certain decisions relating to legislative powers affecting public interest, the leading case being *Nebbia v. New York* (291 U.S. 502), in which the right to regulate the price of milk in an emergency was held not in violation of the due process clause of the constitution. It now seems to be

generally recognized that in time of a major emergency, price control commensurate with the emergency at hand, would be constitutional, and that Congress may enact such legislation as may be considered necessary to limit profits through taxation and industrial licenses.

The history of H.R. 5529, 74th Congress, (the so-called Nye Bill), its principal features relating to industrial mobilization, and the indorsement given these features by the War and Navy Departments, are all set out in the 1936 Industrial Mobilization Plan and will not be repeated here. While we may personally disagree with some of the principles announced by members and associates of the Nye Committee, the fact remains that the necessity of industrial mobilization plans for a war emergency was emphasized and brought to public attention by the various committee hearings, and responsible officers in both the War and Navy Departments found it necessary to give this phase of war planning concerted attention and study.

H.R. 5529 was placed on the Senate Calendar June 15, 1936, but no legislative action was taken on the bill as Congress adjourned June 20th.

The war control measures proposed in Title III of the bill are in general the same basic controls proposed in the legislative annex of the 1933 plan. The enactment of such peace time legislation would give the services a sound legal basis for procurement planning, and avoid confusion and legislative delays at the time of an emergency.

Authority for price control, enforceable priorities and licenses

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with penalties for non-compliance, the transfer of duties and functions of various executive agencies, and authority to eliminate the restrictive provisions of such laws as the Walsh-Healey Act (Pub. No. 846, 74th Congress), in time of a national emergency, are all emergency measures not included in the war powers of the President but are in fact within the war powers of Congress. To have permanent statutes delegating these controls to the President in time of war and giving authority to exercise these controls on M-day through necessary agencies and personnel, are essential measures of national defense, and the public should be informed of the industrial plans based thereon.

Worthy of note is the fact that the Democratic platform recently adopted at Philadelphia carries the provision that that party would continue "To work for peace and to take the profits out of war". Recent developments in Europe have made our nation defense conscious. What part the now defunct H.R. 5529 will play in the next Congress is problematic.

DISCUSSION FOLLOWING LECTURE
"WAR CONTRACT PROCEDURE"

by

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The Army Industrial College,
January 6, 1937

Q. Have all the peace time statutory restrictions been considered in the drafting of these war time contracts, or have you considered that they would be repealed at the outbreak of war?

A. The hope is to get a general clause in the emergency legislation proposed to cover all of the peace time restrictions.

Q. And that has been considered and is being passed in the drafting of these contracts?

A. That is right.

Q. I had quite a lot of questions but Major Fenn has taken most of the wind out of my sails by pointing out this compulsory contract a man has to accept whether he wants to or not. These contracts have been submitted to industry and legal authorities for study - I just wondered what the reaction is of an aggregation such as the United States Chamber of Commerce, or legal organization such as the American Bar Association? Have they commented on this specific contract?

A. Since this has been approved by the War Department Board, the next move is to send it out for comment. We will probably

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get those comments back, just as we have on the others. As to whether or not we would take it up with the American Bar Association, I do not know that they would be particularly interested. However, your suggestion may have some merit.

Q. One of the legal requirements regarding any contract is that it be definite. This, of course, is most indefinite as to the amount of the fee that a man is going to get. I wonder if the committee that has been working on this believes that it would stand up in court?

A. Yes. No question about that.

Q. Of course, it is appreciated, I suppose, by the board that has been working on this that it will be most difficult to operate from the contracting officer's standpoint? If a contracting officer had a thousand of these contracts he would, of course, have to have possibly a legal man or a very efficient man in this man's plant to figure all of these things and to determine when and in what amount payments will have to be made. It is appreciated, isn't it, that it will be extremely difficult to execute this contract?

A. Yes, but we are developing into that system in time of peace. Look what we are doing with the Air Corps contracts. Right now we have to keep cost accounting on every Air Corps contract made, and there are forty million dollars to be spent in a cost accounting system similar to that which you have here. I may say in that connection that the Air Corps has four auditors on this work and they

think they may have to increase that number in order to carry on similar cost accounting as you have under this contract. The Navy is doing the same thing under the Air Corps contracts and ship contracts, under the Vinson Act - exactly the same practice as we set out here. There is nothing new and startling under this system, and do not forget that this contract is not one of ordinary use. During the World War between seventy-five and eighty-five per cent of the money value of War Department contracts were under fixed price contract. This is only a contract to be used where you cannot get a set bid price, either by negotiation or competition, and you are up against it and have to do something. We hope under this contract to provide for the Government practically taking over the man's plant, paying him for the use of it, and using his management, facilities, and ability to produce what the Government needs.

Q. I have in mind four or five things that were not clear to me. On pages four and five of the contract, it says the Government not only pays for direct labor and materials but also for such necessary buildings and machinery as are put in. Looking at it from the viewpoint of just an ordinary crook, wouldn't that allow the man to build a complete aircraft factory, since we only have five or six in the country?

A. We hope that any aircraft factories will come under what we call "The Construction Contract", either under a fixed price basis or evaluated fee. If you cannot get any negotiated price for airplanes, it would be under the management phase of a contract of this kind.

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To answer your question, if the man hasn't enough money or cannot get enough money to build additional buildings and to buy the necessary equipment, we have to provide in a contract of this kind the necessary purchase by the Government at Government expense. You will notice that that is in brackets (in contract), which may be misleading but it is in there for the purpose of use, if necessary, under a particular circumstance of that kind.

Q. I wondered why you did not pay fifty per cent, looking at the loophole in it from the crook's viewpoint? Isn't that legally possible? Why shouldn't the Government only pay fifty per cent of the cost of the buildings and machinery instead of putting up the whole amount of money?

A. If the Government is going to pay for the buildings at cost, the machinery and buildings are going to belong to the Government.

Q. Yes, but over on one of these later pages it says the Government owns the buildings but must remove them at the request of the contractor.

A. That is right. There is no other way to do it.

Q. Why doesn't the Government buy the ground?

A. It would make the situation too involved to buy the ground or lease the ground. We want production. Those are things that will have to be settled after the war.

Q. I have another question. On Page 1 of your Direction for Preparation it says that if it is deemed necessary to include

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an article on patents the following will be used:*** When would it be necessary to use that patent clause?

A. You are interested in the Air Corps. Suppose one of your aircraft factories did not have the patent on one of your Martin planes, or the other planes whatever they may be, and you want to give it in peace time to a competing establishment, you would have to have the patent clause to cover the manufacturer who is manufacturing an airplane that the other fellow has the patent on. This is an exact duplicate of the peace time patent clause. We made no changes in it.

Q. It says that the manufacturer shall hold and save the Government harmless for the use of any patents.

A. Yes, but it says further down that he must list the patents that he believes he is violating - "Where any patent or patents are to be excepted from the operation of this article, such exceptions will be specifically stated, by reference to the patent number." It is provided that the Government then will protect him as to the infringement that may come up under the patents that he lists.

Q. In case a patent is used under those conditions, how does the patent holder get redress?

A. An act which was passed in 1904, I think, set up statutorally how much he shall recover if he does not agree to the license.

Q. Is it from the Government or the manufacturer?

A. If it is for Government production and he has made that

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particular patent an exception under this contract, then the Government would defend it.

Q. If the Government is responsible, why put that in?

A. This is an exact duplicate of the peace time contract.

There has been no change. It works now just as it would work in time of war.

Q. In recent years, and especially in recent months, we have witnessed considerable success on the part of certain labor organizations to establish rights to collective bargaining by a very small group. Has any thought been given to the possibility of having to enter into contracts with such organizations for labor?

A. Yes, but we cannot cover the labor clause in a contract at this time. I think we put in here that it would depend upon the situation. That is something we cannot guess at, we will just have to meet the situation when it is here. We had a few strikes during the World War but they did not amount to much. The proclamation of President Wilson at that time requested that no strikes be held and that disagreements be taken up after the War, and it worked out quite successfully. If we go into a war without the cooperation of labor and without the cooperation of industry - we better stay out of war, I would say. We have to expect these things to happen.

Q. Specifically, if such an organization were headed by one man, a C.I.O., and you couldn't obtain labor without being able to contract with this small group, then what would you do?

A. Well, in the first place I am going to dodge that by

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saying it is not a question involved with the Legal Section of the Secretary of War's Office. I better keep my hands off anyway of anything political - matter of labor in time of war - the American Legion and somebody else.

Major York: We have a problem coming later in the course on the handling of labor and it might be well to defer that particular question. It is a good point - keep it in mind.

Q. I should like to preface my remarks by saying that Mr. Knudsen told us that ignorance breeds argument, and I am ignorant, but it seems to me that this contract that the Judge Advocate General's Office has evolved is certainly anything else but simple. There are ramifications galore all the way through it. I would like to ask why, for instance, you selected the replacement value? I know that you went into that, but at the same time values change and they are bound to go up during war time and if you take replacement values as a basis for rental it would seem to me that you would never be able to come to an equitable conclusion with the contractor as to what the basis would be. I have selected that one point because this whole contract appears to me to raise questions of a similar nature and I believe that before you finish your conclusions as to what payments should be made, and your compromises with the contractor, that you probably will have a bureaucracy built up to handle it that would be stupendous, and certainly during war time simplicity, above everything else, should be the object for which to strive. Would you enlighten me just a little bit on that score, sir?

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A. I shall be very glad to. In the first place, you speak of the simplicity of the contract and criticize it because it is quite voluminous. I admit that it is rather involved, but my answer to that is: when your committee comes along with the so-called "Adjusted Compensation Contract" and you have studied that, if you don't think this is a whole lot more simple than the proposed Adjusted Compensation Contract I shall be very much surprised. Any contract based upon a theory that the Government has to face in a situation of this kind is bound to be involved. The Cost-Plus contracts we had during the World War, most of them, were terrible as far as being involved was concerned. The four hundred contracts that the various supply arms and services used were all involved. They all built up their own peace time procedure and when war came along they used that same procedure. It was one whale of a job interpreting what they meant. I think we have done a pretty good job on this contract. It is not as involved after you study it as it may appear at first.

As to your point on the replacement value, the first comment I would like to make on that is: don't forget you have your depreciation element in there. It is not replacement value as of today but it is replacement value today less depreciation, how ever caused. That is a business term that all commercial institutions understand and it is one, as I have said before, that fire insurance companies make on their reimbursement to the contractor for his loss. If you take the actual cost as advanced by the Valuation Division of the Internal Revenue Bureau less depreciation, you are going to run into a whale

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of a snag because business, as a rule, says, and I am quoting from those that we have contacted, that those set-ups in the Internal Revenue Bureau are matters entirely for tax purposes and they divorce them entirely from the commercial value of their establishment. Further than that, they say that they have taken large depreciations for tax purposes only. Now whether there is merit in coming along after you put the burden on industry so as to make a fair return, and they are paying taxes on that, when the Government wants to rent that establishment in time of war switching over to present value, I cannot say. There are certain ethics on both sides, but if you are going to get the cooperation of industry you have got to take what is the present every day value of the investment in that property. I do not know how you are going to get away from it. Under the theory of the Internal Revenue Bureau, supposing back in 1929 an industry was purchased at ten per cent on the dollar and you bring that up under a contract such as is contemplated here and give him 4.7 on that ten per cent when in reality if it is based on replacement value less depreciation you have actually the market value of that facility at the date of your contract - it seems unfair to give this fellow only 4.7 on the ten per cent because he happened to get a good bargain in purchasing that particular plant. The Treasury says that that is all the money he has in there and that is all the return he should get on it. We cannot agree with that because it is not fair to the manufacturer and after all you have got to consider the manufacturer. As to the fluctuation of price, we can only hope that under these

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contracts the fluctuation will not be so great as to make a material difference in the evaluation of the facility, and don't forget this, and this is an important point and one that I tried to bring out here, you are only giving him a percentage on this investment - you are giving him 4.8, or whatever figure you may arrive at. It may be changed in war. Suppose you make a fifty per cent error on that, what difference does it make? Think of the profits that were made in the last war in some instances. The differences in the variation of your fee isn't going to be considerable even if you make an error of fifty per cent.

Q. However, I desire to raise this point: I do not quibble with you at all on whether or not theoretically all this is beautiful. For instance, your wage and management theory, I think, is perfectly splendid in theory. I am not quibbling about what should be, I am quibbling about what is practical, and I still submit that although it is very good theory, very good Major York economics, to say that management should have its way and that your depreciation should be figured upon replacement value - it is quite another story as to how that replacement value is to be computed. Likewise, I know, as you state, that business thoroughly understands what is meant by replacement value, but when you try to get together with business to determine replacement value without a board set up by contract to adjudicate you are going to have much more trouble, I am sure, than what I gather from your remarks you anticipate.

A. Let me read you this statement. The Class may be interested.

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It is an important point, and there are a few remarks put in by McCrossan and Company. McCrossan and Company are well established engineers in New York.

"As a matter of fact, appraisals of manufacturing property should and can be made expeditiously and harmoniously. Such appraisals are being made daily in great numbers throughout the country by plant owners themselves, engineers, and many appraisal organizations, some of them with offices, and many are devoted exclusively to industrial appraisal work. Appraisals are required for all kinds of property damage and insurance. Virtually every electric, power, water, supply, and transportation utility must of necessity have appraisals for rate making purposes. Real, property, income, corporation, and other forms of tax are based on or closely related to appraisal values. While accurate statistics are not available, it is probably correct to say that a great proportion of the manufacturing establishments in the country already have appraisals which are either recent or can be brought up to date in a very short time. Appraisals and appraisal methods are an inseparable part of the fire insurance business. The sale of insurance and settlement of claims by insurance companies depend wholly upon the valuation of the property insured. A very large portion of fire insurance policies issued in this country carry clause. Under this clause the property owner agrees to carry insurance in an amount equal to eighty, ninety, or a hundred per cent of the total sound value of his property, as the case may be, and his premium rates are computed accordingly. There are hundreds of fire insurance companies in the United States and many foreign insurance companies licensed to write insurance in this country. It is a matter of common knowledge that only a comparatively small number of industrial manufacturing properties in this country are not insured. In view of the fact that appraisals and valuations are such an intricate part of the fire insurance business, it is apparent that appraisals and valuations must not only be a routine phase of that business but that they are always effected without undue delay or friction. At times hundreds

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of thousands of dollars of losses occur throughout the United States, sometimes daily. These losses could not be settled if in the determination of the losses there is hostility and friction. If such were the case, it would present an intolerable and unprofitable situation to both companies, I am sure."

I will not read you any more but that is along the general line.

Q. I still do not believe that would solve the problem. I think that, again, is beautiful theory.

Colonel Harris: Let the gentleman give us his idea as to how the problem should be solved.

Q. I do not see any necessity for a rental clause that just further complicates the contractual relationship. I don't know much about it - as I said, I am ignorant on the subject and that is probably the reason I am arguing about it, - but nevertheless I do believe that rental is unnecessary. I think it is sound economic theory just as wages and management are sound economic theory, but I do not think it is necessary practically, and furthermore, pursuing the problem just a little bit more deeply, it seems to me that in taking profit out of war you are going to take incentive to produce away, and I do not think the services should take that lying down. Maybe the Nye Committee will so influence the country that it will have to be accepted as Gospel but at the same time I think it is not going to produce what we want in war time and that is production to the nth degree. I do not think that contracts like these are going to encourage people who are reluctant to enter into definite price agreements. I don't think it is going to encourage them at all to produce. If I were one of them I certainly would not want to be tied

up with a thousand different ifs and ands and buts such as we have in these contracts. If I do not have a lot of capital certainly I would want to be using all the capital I have in war time - I would not want to worry about getting my money, but if I do not agree to everything everybody says here in the Government my money is going to be held up. It can be adjudicated - perhaps get something by way of salary.

Colonel Harris: I suggest we put you on the Contract Committee so as to get your views. We have to have contract forms when we start out. It isn't a question of whether they are right or wrong, we have to have them and they have to be workable. We would be glad to have your ideas as to what to replace these contracts with.

Q. I guess this is the proper time to sit down and be quiet, but I still will not accept anything like this without question.

Major York: This sounds like making the fellow in camp cook because he doesn't like the food.

Q. In answer to Commander Foster and in defense of this contract, I should like to say that for three years I was on the Contract Board up in the New York District and associated with the manufacturers on that Board. In fact, they were all manufacturers on the Board except the two Regular Officers connected with Ordnance. These manufacturers, incidentally, were probably the largest in the ^{manufacturing} field - they were the largest in the area - several of them being in the ten million dollar class, and the bigger they were the more pleasant relations with them were. We did not find one of them who would be unwilling to sign a contract with the Government without a particular profit. They asked

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sufficient to take care of their expenses but they did not, in any case, ask for unreasonable profits. Although there were minor points (this happened to be the Adjusted Compensation Contract) which they did not exactly agree with, they did agree in principle with that contract so long as they were protected against loss in taking the contract. They just did not want to incur a loss in taking a contract. As Major Penn said, about eighty-five per cent of them said: "If we haven't planning sections that are good enough to be able to determine a fixed price for the articles we will furnish, our firm is pretty darn poor because we get that kind of job all the time and we have to determine on new things at all times."

Q. May I ask whether or not I understood correctly the statement that these contracts are only to be imposed upon those who will not, for one reason or other, enter into fixed price contracts?

A. I would not say "imposed" - I would not put it that compulsory. It is a form to be used where a fixed price contract is not considered reasonable - the price given on the part of the Government - or you cannot have competitive bidding.

Q. I have two or three questions, but I would like to first make a statement in defense of Commander Foster's position. We have the so-called "Recapture Clause" - profits on railroads - and I think we have had a bureau in existence for about forty-nine years trying to determine the value that we have written into this contract, so there is something to be said on both sides, but that is all right, that is a good legal job for the fifty years after the next war - making this determination

of fact.

There are two schools of thought on this constitutional question: The Powers of the President. One, taking the school of thought of Abraham Lincoln, they are limited by statements in the Constitution; that the powers of the Legislative are only those definitely stated in the Constitution. The second school of thought says that that condition does not exist - the powers of the President are only those definitely stated in the Constitution - applying, of course, in the two cases of invasion or rebellion. My first question is: which school of thought would you say we lean toward in the War Department? If it is the school of thought that the powers of the President in time of war are unlimited, then is there any necessity for this additional legislation? That is the second question. The third question I had in mind is political so I will withdraw it.

Colonel Harris: That question can be answered. The War Department has determined that it is desirable to have this legislation.

Major York: Are you on War Powers?

Major Lyon: Yes sir.

Major York: I think you will find that the previous Committee Reports on that problem have pretty much come to the conclusion, haven't they, that those powers are unlimited?

Major Lyon: The Committee hasn't come to that conclusion.

Major York: Not yours, but previous committees.

Major Lyon: Yes, but there is a whole lot of thought on the other side.

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Major York: Being no dogma here, you are free to take the other side. The reason why I mention that is the fact that that rather points toward the fact that in the past, at least, people have sort of believed with the school of thought that those powers were unlimited.

Major Lyon: That is correct. If the powers are unlimited, we do not need this legislation - that is my point.

Major York: Maybe as a matter of strict legal theory, but as a matter of practical operation it might still be a good idea to do it even if you didn't have to, for political and other reasons.

Q. I will just say a little bit along Commander Foster's line. After reading this contract very carefully, I do not see any great difficulty for the contracting officer in it. While it looks involved, it isn't when it is all worked out. It looks like it would be very easy to handle as an officer in the field with the contractor.

I have one question. We have heard a lot about economic royalties, and on page seven, among the items which will not be included to be paid by the contracting officer is the item of excessive salaries. My question is this: Has there been any study as to what an excessive salary would be interpreted as being?

A. I will answer your question, if I may, by referring you to the bottom of page seven. That is as close as we thought we could cover it in this contract, and that is put in at the recommendation of the Bureau of Internal Revenue. "In the case of officers salaries, no increase shall be allowable after the declaration of war for the purpose of computing overhead under this subsection."

Q. Anything would be considered as a reasonable salary?

A. I would not say "anything". You are getting into the upper bracket.

Major York: A lot of these people that get these enormous amounts of money get them in the way of bonuses - Bethlehem Steel, etc. - rather than salary, at least part of it. However, I do not know what the provision is about bonuses.

Major Penn: In answer to Major Lyon, here are appraisals that have been made very recently: Plan A. Appraisal Value - four hundred forty-two thousand took three men seventeen days. I will jump down to a big one: two million, fifty-five thousand took six men twenty-nine days - one hundred seventy-four working days. This is on an appraisal on which you have to go down into the detail of the value. It isn't contemplated that the same preciseness would be used under this particular form of contract as where you are refinancing or reissuing certificates of that kind. I admit what you say on the public utilities - the railroads. The Interstate Commerce Commission is principally concerned with railroads and they have had a whale of a job. The job must be considered a big one because they have immense properties to consider. If we had to take over a railroad under this form of contract - I do not think we better use this particular means of doing it.

Q. The same question arose in my mind in connection with the sound valuation theory that Commander Foster mentioned. I thought of repercussions and possible litigation that might follow. Then I thought of the numerous valuation theories developed by the railroads, such

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as the prudent investment theory, etc. The railroads have never established a permanent appraisal valuation. As Major Lyon stated, the railroads have spent 49 years attempting to find a solution to this problem. I believe the valuation theories proposed for the purpose of establishing rates for railroads will never be permanently settled. However, the railroads have an entirely different problem to settle with respect to valuation. The valuation established by the railroads is a basis upon which rates are approved as a percentage. A fair return on a fair investment for adequate transportation furnished the public. The railroad valuation problem, therefore, is an entirely different question than that of placing valuation on a manufacturing plant. Thus after very careful consideration I believe the committee has done an excellent piece of work in developing these contract forms. I wish to heartily congratulate the committee.

Q. I want to bring up a phase of this question which I think was touched on more or less several times during the discussion but which seems to me absolutely vital. We have been focusing our attention in this country, as evidenced by the attitude of the Nye Committee, on the question of taking profits out of war. I think one of the most interesting and important statements that I have ever heard was made to the Nye Committee by Colonel Harris when he said that in time of war efficiency is desirable but effectiveness is mandatory. In other words, we want that production. How we can expect to get the maximum production unless we have the cooperation of the management of industry, particularly, is beyond me. I cannot imagine a plant turning out its maximum capacity if the management are smarting under a sense of injustice of having a contract forced down their throats that they think is absolutely unfair, that violates their feeling or spirit of justice, and I think that it is absolutely essential in drawing

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up these contract forms that we do not lean over too far backwards in the attempt to limit the return to industry to the point where they are going to consider the contract unjust to them. Of course, that is a question of judgment but it is a very important factor, in my opinion, and I do not think on a moment's thought any one will disagree with me. You have got to have the cooperation of the industrial management to get production.

As far as the complications are concerned, you mentioned the Interstate Commerce Commission and railroad evaluation. It is true that has been a difficult problem, but, on the other hand, it seems to me that we had just about as knotty problems after the war in adjusting those questions that came up as is conceivable, and if my recollection is correct it wasn't so very long after the war until the vast majority of those questions had been pretty well settled, so we have that as the guide indicating that those questions are not insuperable. I do not see how you can get away, as you said, from the complications where you are expecting a manufacturer to finance the production on an immense scale on something which he has never manufactured before, that he has had no experience in and doesn't know what the prices of labor and material are going to be, and even if he did he would not know what his costs are going to be. Those who have had any manufacturing experience know that when you attempt to manufacture a new article, or to estimate what it is going to cost you to manufacture something which you have had no experience in, which may be quite different from what you have manufactured before, if your estimates are accurate it is just luck.

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There are too many unknown factors entering in and it is absolutely essential that we have a type of contract which will protect the manufacturer without injustice to the Government, and I do not see how you can get away from a certain amount of complication. It cannot possibly be made simple.

Q. I have two questions I would like to ask, if I may.

One of them is with respect to the matter of interest. I may have missed something in hasty reading of this form, but I notice on page six that the compensation does not include interest on outstanding debts owed by the contractor, "except for monies borrowed to finance this contract, as determined by the contracting officer." Therefore, the contractor will be paid interest on monies which he has borrowed for the specific purpose of furthering this contract.

A. That was a matter taken up at the time this contract was considered, and from the words: "except for monies borrowed" that has been deleted from this contract.

Q. Of course, interest is a real cost to the contractor whether he borrows money for that purpose or whether he is using his own money. It seems that it is cheating the contractor out of four or five per cent, depending on what interest is at that time.

A. That is a matter receiving consideration by the Board.

Q. The other question I have in mind is the amount of fee that is to be received by the contractor. Of course, there was a great deal of objection during the war to these so-called "Cost-Plus" contracts, and there seems to be an inference that by having this

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sliding scale fee - four per cent for the first one hundred thousand and then reducing it to ninety-two hundredths per cent for the total thirty million, that we have eliminated the encouragement to the contractor of increasing the cost, but that isn't really so because although he doesn't get an additional four per cent on the next hundred thousand or two hundred thousand or next million dollars he does get some per cent on it and it really is to his advantage to have even a higher cost on this basis even though much more less so than on a strict Cost-Plus system. I wonder whether any thought has been given to a system of trying to establish a fixed fee in the beginning based on some estimate of the grand cost of the contract, or by some similar method? I do not know that this is practical at all - I haven't given much thought to it - I only raise it as a suggestive sort of question - rather fixed in the beginning and then perhaps give him a bonus if he does the work efficiently by bringing down the total cost of the contract instead of bringing it up, or perhaps giving him a little discount if he increases the cost too much?

A. That has been considered, but it is considered rather dangerous because there you are getting into the estimate of cost and basing your profit on the cost. What is going to happen is that he will get his estimate up as high as he can.

Q. If you had any command of competition, that would be one element of competition as to the amount of the fixed fee to be established in the beginning.

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Major York: Concerning the Liberty Engine case, the very best automobile people in the country thought the building of the Liberty Engine would require sixty-four hundred dollars or something like that. When it got into production, Nordick-Marmon got the cost down to thirty-one hundred dollars. When they got into the thing and they stood to make so much money that they would not know what to do with it, they finally revised the contract. There is where they made a hundred per cent error in the estimate of cost, and the estimate was made by people who were supposed to know.

Q. I am not trying to pay them that whole profit; I am just trying to give them a little bit of an additional fee based on the fact that instead of their charging six thousand dollars for the engine they are only going to charge three thousand dollars for the actual cost and get a little more fee because they have been able to bring it down to that amount. Maybe they should have brought it down to that amount - the six thousand dollar estimate may have been wrong. It introduces an entirely different principle and instead of encouraging in any way additional cost to be incurred by the contractor it would encourage him to reduce the cost by all means possible because the more he reduces the cost the more fee. On the other hand, the more he increases the cost the less fee he would get.

Major York: That is the reason why the Nordick-Marmon people were going to make money - they were supposed to be given twenty-five per cent of all they could put on the cost. It is a very complicated problem.

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Q. Am I correct in the belief that this type of contract depends upon universal acceptance of standard cost accounting systems and standard national adjustment systems?

A. I think generally so.

Q. That should clear away a lot of these difficulties brought up.

Q. In reference to the statement of Colonel Schulz in connection with an estimated Cost Plus profit contract, I wish to state that this principle is one of the methods used by the Navy. However, the estimated cost is adjustable, and provision is made for a bonus or a deduction, according to the terms of the contract. This is only one of the principles involved, however, in numerous methods.

Q. I should like to comment on Colonel Stuart's thought that production is what we want, and it certainly is the basic idea, but I do not think that we need to worry about it from the Army point of view. Certainly they will take care of that. Looking at it from the viewpoint of the crook once more - the holes in the contract - take the question that Major Andrews brought up about the salary that is in existence on the day of war - they certainly can boost their salaries from twenty thousand to forty or fifty thousand two or three weeks before the war when they know it is coming. Also, in the airplane contract, where they can get complete factories built on their own ground, a first-class crook (pardon) with legal training would certainly be able to find many loopholes in any contract so that they would make a good profit. I don't think we need to worry about them cooperating with the Government

Q. In a Democracy, such as we have, the avalanche of the

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majority rules. We apparently have proponents of contracts based on that thought. Major Naughan just brought out the point that if this read: "No increase prior to ninety days of the declaration of war" it would protect the Government's interests somewhat.

A. I will make a note of it.

Q. It seems to me that while we have been so careful to protect the interests of the Government we have opened up a large field for collusion. Now, of course, we are all honest - that is an accepted theory - but this reads: "In addition to the above allowances, further allowances of cost may be made from time to time by the contracting officer with the written approval of, or by the written direction of, the head of the department, same to be incorporated as a part of this contract." Now that is broad, and we all know that when we are all busy during time of war we are going to have very little time to give to ferreting out the real reasons for many increases and it certainly opens up an opportunity for collusion, which I hope and we all hope will never happen.

A. If you cannot trust the control to the chief of the department, you are in bad shape on these contracts.

Q. If the individual was going to do that - of course, we all know that is impossible.

Colonel Harris: I would like to make a few remarks. This subject always brings up a discussion and it sometimes gets a little acrimonious, but we are up against the practical responsibility of getting out a contract and having it ready. When we start a war we

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have got to have contract forms ready. I have the responsibility of having contract forms ready, and we are doing the best we can. There is no contract form that you can possibly describe that is not susceptible to abuse and to excessive profits. I was out at Milwaukee recently and met a representative group of contractors there. I talked to them about this question of contracts in war. They all realized they had to do what the Government told them to; they were all prepared to do their best. They were all more concerned about not losing money than they were about making money. As conversation went along, these contractors, and many of them are producing commercial goods, said: "In time of war I would want to be assured of not losing money; therefore, I want some kind of contract where the Government pays the costs. I want to waive my chance of excess profit but I want to be guaranteed against loss." I said: "We look with disfavor on Cost-Plus contracts of any form, and if we use a fixed price contract, where you estimate the cost, what will you fellows do?" Every one of them said: "We will put our cost up so high that we will not lose and the Government will get gipped. This Liberty Motor contract that was referred to a while ago is a very good illustration. I am more afraid of the estimate of cost and the abuse of the estimate of cost on a fixed price contract than I am of any difficulty on this so-called "Fee Contract". We haven't got a single thing that is being produced in quantity in this country today that is non-commercial in character. We are going to require these things in time of war by the thousands and mass production is going to reduce those costs to a marked degree, but in time of

peace they do not know that and are not willing to fix the price lower than they can see they can make it at the time.

With reference to this subject of contract forms - it always develops an argument - the Planning Branch itself has the responsibility of having contract forms ready and if we do not have them ready we will fail in our responsibility, because on M-Day the Government has to say three things and no one else can say them. The first is: What do you want? - Specifications. Second: How much do you want? - Requirements. Third: The legal instruments necessary to start production. I know it is a difficult problem but I personally believe that this is a far step in advance of the Adjusted Compensation Contract, because instead of having eight things to settle we have now reduced it to two and the two that are of most interest in time of normal operation. If fire insurance companies can pay millions of dollars of damages and have that accepted by the man that sustained the loss on a seventeen day time of six men to do the work I think we are inclined to magnify the difficulties of arriving at a sound value.

Captain Allen: I am delighted to see the advance in the knowledge of this subject that has been shown in the consideration of the subject. This year a far clearer statement of the whole problem of purchase in war has been given than we had during the period last year. The only doubtful feature I can see in the picture now is the question of standard accounting. I greatly doubt whether the progress toward a standard accounting system throughout the country has advanced very far. My understanding last year was that there were probably twenty

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hundred different methods of accounting and I think we should lend our efforts toward standardizing the accounting system to be used, if it is possible to do so.

Commander Hendren: I think Major Fenn has done a very commendable job. There are two or three things that occurred to me that I believe are more or less easily cleared up. One was the connection this contract has with allocations. As I understand what Major Fenn said, it is contemplated to use this contract in competitive bidding and accept the lowest three bidders, perhaps. Is that true, Major, in connection with items which have not been allocated?

A. I made that statement, Commander, in reference to fixed price contracts. I think we are inclined to believe that there will be no competition between allocated services, and I think we had better get away from that and go along on the idea that we will get competition wherever we can, wherever it is possible, even among allocated services.

Commander Hendren: One other thought occurred to me that is nothing more nor less than a personal opinion. I think the question of antagonizing industry or business is probably not as serious under this contract as it might appear to be because, after all, industry and business and such organizations as the United States Chamber of Commerce have had a pretty thorough dressing down by the Government in the last three or four years and I think that perhaps in time of national emergency they will have been sufficiently subdued to not remonstrate too much, and perhaps that will make the solution of the problem a little more easy.