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# MILITARY LAW REVIEW

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## A Symposium on Procurement Law

### JUDICIAL AND NON-JUDICIAL REMEDIES OF A GOVERNMENT CONTRACTOR

*Lieutenant Colonel John F. Goodman, Jr.*

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### REDUCING STATE AND LOCAL TAX COSTS TO COMPETE MORE EFFECTIVELY FOR GOVERNMENT CONTRACTS

*Lieutenant Colonel Karl E. Wolf*

### OFFSHORE PROCUREMENT

*Lieutenant Colonel Robert S. Pasley*

### BID GUARANTEES IN FEDERAL PROCUREMENT

*Robert H. Rumizen and Milton J. Socolar*

### THE EMERGENCE OF THE CURRENT INTEREST IN THE DEFENSE SMALL BUSINESS AND LABOR SURPLUS AREA SUBCONTRACTING PROGRAMS

*Irving Maness*

### THE NEW DEFENSE PROGRAMMING CONCEPT

*Laurence E. Chermak*

### PROPRIETARY DATA IN DEFENSE PROCUREMENT

*William Munves*

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HEADQUARTERS, DEPARTMENT OF THE ARMY

OCTOBER 1962

## PREFACE

The *Military Law Review* is designed to provide a medium for those interested in the field of military law to share the product of their experience and research with their fellow lawyers. Articles should be of direct concern and import in this area of scholarship, and preference will be given to those articles having lasting value as reference material for the military lawyer.

The *Military Law Review* does not purport to promulgate Department of the Army policy or to be in any sense directory. The opinions reflected in each article are those of the author and do not necessarily reflect the views of The Judge Advocate General or the Department of the Army.

Articles, comments, and notes should be submitted in duplicate to the Editor, *Military Law Review*, The Judge Advocate General's School, **U.S.** Army, Charlottesville, Virginia. Footnotes should be set out on pages separate from the text and follow the manner of citation in the *Harvard Blue Book*.

This Review may be cited as Mil. L. Rev., October **1962** (DA Pam **27-100-18**, 1 October **62**) (number of page).

For sale by the Superintendent of Documents, United States Government Printing Office, Washington **25**, D.C., Price: \$.75 (single copy). Subscription price: **\$2.50** a year; **\$.75** additional for foreign mailing.

PAMPHLET  
 NO. 27-100-18

HEADQUARTERS,  
 DEPARTMENT OF THE ARMY  
 WASHINGTON 25, D.C., 1 October 1962

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**A SYMPOSIUM ON PROCUREMENT LAW**

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# A SYMPOSIUM ON PROCUREMENT LAW

## FOREWORD

Illustrative of the magnitude of the Department of Defense procurement program is the fact that of the Department's current record annual appropriation of approximately 48 billion dollars, roughly one-half is earmarked for procurement. It is axiomatic that, where and under what terms and conditions the Government's procurement dollars are spent will continue to have a tremendous impact on this nation's economy.

To assure that the Government receives the maximum benefit from each procurement dollar, innovation and refinement are the watchwords of the procurement system. Thus it is that the role of the Armed Forces lawyer in procurement matters is becoming of increasing importance. Whether it be to assist in formulating practical policies and procedures that reflect and implement the spirit of the statutory framework within which procurement is to be effected, or whether it be to give guidance and advice to resolve the everyday problems of contract administration, the challenge to the lawyer is increasing.

The Judge Advocate General's School, Department of the Army, through its courses in procurement law and its publications, has become recognized as the outstanding center for instruction in procurement law in the Government. Its students are not only members of the Judge Advocate General's Corps but also representatives of the other military services and agencies of the Government.

The articles that comprise this symposium were chosen for a dual purpose: first, to present material of substantive value written by recognized authorities in various fields of procurement law; and, secondly, to present to those having limited acquaintance with procurement law a cross-section designed to illustrate the controversy and the constant change that make the practice of procurement law the fascinating and demanding task that it is. If this symposium results in a better understanding of the wide vistas of procurement law among the latter and in a more flexible and knowledgeable approach to problems among those now working in that field, the efforts underlying its publication will have been amply rewarded.



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# JUDICIAL AND NON-JUDICIAL REMEDIES OF A GOVERNMENT CONTRACTOR

BY LIEUTENANT COLONEL JOHN F. GOODMAN, JR.\*

## I. INTRODUCTION

It was early decided that the United States Government has a right to enforce the performance of its contracts, or recover damages for their violation, by bringing suit in its own name.<sup>1</sup> On the other hand, suits against the United States for breach of contract may not be brought without specific statutory authority, which of course results from the application of the doctrine of sovereign immunity which is strictly construed.\* Isn't this a gross inequity? Before this question can be answered let us examine where the United States has consented to be sued and what other remedies, non-judicial or administrative, it has granted its aggrieved contractors.<sup>3</sup>

## II. JUDICIAL REMEDIES

### A. CLAIMS FOR CREDIT

Title 28 of the United States Code, Section 2406, provides:

In an action by the United States against an individual, evidence supporting the defendant's claim for a credit shall not be admitted unless he

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\* The opinions and conclusions expressed herein are those of the author and do not necessarily represent the views of The Judge Advocate General's School or any other governmental agency.

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<sup>1</sup> *Dugan v. United States*, 16 U.S. (8 Wheat.) 172 (1818). Suit may be instituted in a United States District Court (28 U.S.C. § 1345 (1958)) without regard to the amount in controversy (*United States v. Sayward*, 160 U.S. 493 (1895); *United States v. Johnson*, 102 F.Supp. 818 (D.N.D. 1952)) or the citizenship of the defendant (*United States v. City of Salamanca*, 27 F.Supp. 541 (N.D.N.Y. 1939)) or suit may be brought in a state court (*United States v. Jacobs*, 100 F. Supp. 189 (N.D. Ala. 1951)).

<sup>2</sup> *Lynch v. United States*, 292 U.S. 571 (1934); *Minnesota v. United States*, 305 U.S. 382 (1939). In the latter case the Supreme Court held that a federal court acquired no jurisdiction of a cause removed from a state court that lacked jurisdiction, even though the removal was effected on petition of the United States and the stipulation of the United States attorney. *United States v. Shaw*, 309 U.S. 495, 500 (1940).

<sup>3</sup> A contractor also may—under certain circumstances—obtain relief under the provisions of Public Law 85-804, 50 U.S.C. §§ 1431-35, as implemented by Exec. Order No. 10789, 23 Fed. Reg. 8897 (1958) and departmental regulations. However, this area is beyond the scope of this article.

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first proves that such claim has been disallowed, in whole or in part, by the General Accounting Office, or that he has, at the time of the trial, obtained possession of vouchers not previously procurable and has been prevented from presenting such claim to the General Accounting Office by absence from the United States or unavoidable accident.

This statute, which was originally enacted in similar form in 1797,<sup>4</sup> was designed to allow the defendant the full benefit at a trial of any credit, "whether arising out of the particular transaction for which he was sued, or out of any distinct and independent transactions, which would constitute a legal or equitable set-off, in whole or in part, of the debt sued for by the United States. The object of the act seems to be to liquidate and adjust all accounts between the parties, and to require a judgment for such sum only, as the defendant in equity and justice should be proved to owe to the United States."<sup>5</sup>

However, this statute does not grant jurisdiction to a court to determine that the United States is indebted to the defendant for any amount in excess of the indebtedness to the United States proven at the trial.<sup>6</sup> For example, if the United States were to sue an individual for \$30,000, who set up and proved a credit for \$25,000, and the United States recovered a judgment for \$20,000, the set-off would be allowed to the extent of \$20,000.

### B. THE TUCKER ACT

*Historical background.* The statute providing for claims for credit was for many years the only provision for bringing suits arising out of contract against the United States. If a contractor felt damaged by a breach of contract by the United States, his only relief, aside from the credit statute, was a private bill in Congress. The net result was that private bills became so numerous that Congress was said to be devoting one-third of its time to the consideration of private bills, and congressmen were being "run down by private claimants, and their agents or attorneys."<sup>7</sup>

The first act attempting to relieve this situation<sup>8</sup> failed, for although it established a Court of Claims consisting of three judges who would hear and determine claims founded upon any law of Congress, a regulation of an executive department, or upon any

<sup>4</sup> Act of March 3, 1797, ch. xx, § 4, 1 Stat. 512.

<sup>5</sup> United States v. Wilkins, 19 U.S. (6 Wheat.) 135, 144 (1821).

<sup>6</sup> United States v. Tillou, 73 U.S. (6 Wall.) 484 (1868); United States v. Shaw, 309 U.S. 495 (1940). But see United States v. The Thekla, 226 U.S. 328 (1924), where an exception for admiralty cases appears to exist.

<sup>7</sup> Cong. Globe, 33d Cong., 2d Sess. 70 (1854). For an excellent article on the history of legislation about the Court of Claims, see Hoyt, Legislative History, in 1 Ct. Cl. Digest, at p. xiii (1950). See also The Glidden Company v. Zdanok, 370 U.S. 530 (1962).

<sup>8</sup> Act of Feb. 24, 1855, ch. CXXII, 10 Stat. 612.

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contract express or implied with United States, the "Court" was not given authority to render a judgment on a claim, but was required to make reports to Congress, which took the final action. Subsequent acts<sup>9</sup> added two judges to the court and enlarged the powers and jurisdiction of the court so that the decisions were not subject to congressional approval. One of these acts, the Act of March 3, 1887,<sup>10</sup> was introduced by Congressman John R. Tucker of Virginia<sup>11</sup> from whom the act and subsequent amendments received the name, the Tucker Act.

Pertinent sections of the Tucker Act now appearing in the United States Code provide:

The Court of Claims shall have jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress, or any regulation of an executive Department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort.<sup>12</sup>

The Court of Claims shall have jurisdiction to render judgment upon any set-off or demand by the United States against any plaintiff in such court.<sup>13</sup>

(a) The district courts shall have original jurisdiction, concurrent with the Court of Claims, of:

(2) Any other civil action or claim against the United States, not exceeding \$10,000 in amount, founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort.<sup>14</sup>

*Limitations.* There are certain limitations on the jurisdiction of the courts under the Tucker Act, some of which have resulted

<sup>9</sup> These included the Act of March 3, 1863, ch. XCII, § 1, 12 Stat. 765; the Act of March 17, 1866, ch. XIX, § 1, 14 Stat. 9; the Act of March 3, 1887, ch. 359, 24 Stat. 505.

<sup>10</sup> Ch. 359, 24 Stat. 505 (1887).

<sup>11</sup> 18 Cong. Rec. 622 (1887).

<sup>12</sup> 28 U.S.C. § 1491 (1958).

<sup>13</sup> 28 U.S.C. § 1503 (1958). The Court of Claims has jurisdiction over other matters affecting contractors. Those matters, however, will not be discussed in this article. They include suits against the United States for patent and copyright infringement by the United States, its contractors and certain others, 28 U.S.C. § 1498 (Supp. 11, 1961).

<sup>14</sup> 28 U.S.C. § 1346 (1958). This limitation of \$10,000 has existed ever since the district and the then circuit courts were given concurrent jurisdiction with the Court of Claims in the Act of March 3, 1887, ch. 359, § 2, 24 Stat. 505. The feeling at the time apparently was that the courts away from the District of Columbia might be too free with their judgments against the United States. See 18 Cong. Rec. 624 (1887) (remarks of Mr. Tucker). The \$10,000 limitation on the jurisdiction of the district courts in suits under the Tucker Act against the United States should not be confused with the requirement that, in suits in the district courts involving federal questions and diversity of citizenship, the matter in controversy must exceed the sum or value of \$10,000, exclusive of the interest and costs. 28 U.S.C. §§ 1331-32 (1958).

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from court decisions. Suits may be for money judgments only, and the courts may not decree equitable relief such as specific performance.<sup>15</sup> However, there may be entered a money judgment based on a contract as reformed to accord with the actual intention of the parties.<sup>16</sup> In addition, if the federal government, through its agents and pursuant to an Act of Congress, takes for public use private property, without asserting title to it, suit for proper compensation may be brought under the Tucker Act.<sup>17</sup>

Although the Act gives jurisdiction over "any claim against the United States founded upon any . . . implied contract with the United States," the reference is to contracts implied in fact, not those implied in law.<sup>18</sup>

*Suits against individuals.* As suits directly against the United States for specific performance are not permitted under the Tucker Act, claimants often attempt to do indirectly what they cannot do directly, by bringing a suit personally against an agent of the United States. The general rule is that if an agent is acting within his delegated powers as an officer of the United States, any suit seeking to prevent such action is in effect a suit against the United States and may not be maintained.<sup>19</sup> Conversely, suit may be brought against an agent of the United States if the officer purports to act as an individual and not as an official, he exceeds his statutory or delegated powers, or the statute or order con-

<sup>15</sup> Jones v. United States, 131 U.S. 1 (1889).

<sup>16</sup> United States v. Millikin Imprinting Co., 202 U.S. 168 (1906).

<sup>17</sup> Hurley v. Kincaid, 285 U.S. 95 (1932); United States v. Great Falls Manufacturing Co., 112 U.S. 645 (1884).

<sup>18</sup> United States v. Minnesota Investment Co., 271 U.S. 212 (1926); Hickman v. United States, 135 F.Supp. 919 (W.D. La. 1955); see also U.S. Dep't of Army, Pamphlet No. 27-153, Procurement Law, ch. 1, paras. 7, 8 (1961) (hereinafter cited as DA Pam 27-153). For some cases where an implied contract was said to have arisen because the express contract failed, see United States v. Andrews, 207 U.S. 229 (1907) (express contracts were not reduced to writing as required by law); Clark v. United States, 95 U.S. 539 (1877); Douglas Aircraft Co. v. United States, 95 Ct. Cl. 140 (1941) (express contract was improperly entered into by negotiation instead of formal advertising); Burchiel v. United States, 4 Ct. Cl. 549 (1868); 33 Comp. Gen. 533 (1954) (express contracts violated prohibition against cost-plus-a-percentage-of-cost system of contracting). For cases discussing the measure of compensation payable under implied contracts, see St. Louis Hay & Grain Co. v. United States, 191 U.S. 159 (1903); Clark v. United States, 95 U.S. 539 (1877); Salomon v. United States, 86 U.S. 17 (1873); New York Mail & Newspaper Trans. Co. v. United States, 139 Ct. Cl. 751 (1957); Douglas Aircraft Co. v. United States, 95 Ct. Cl. 140 (1941); 40 Comp. Gen. 447 (1961).

<sup>19</sup> Larson v. Domestic & Foreign Commerce Corp., 337 U.S. 682 (1949); Malone v. Bowdoin, 369 U.S. 643 (1962).

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ferring power upon the officer to take action in the sovereign's name is unconstitutional.<sup>20</sup> However, a suit may fail, because it is against the sovereign, even if a claim is made that the officer being sued has acted unconstitutionally or beyond his statutory powers, if the relief requested cannot be granted by merely ordering cessation of the conduct complained of, but will require affirmative action by the sovereign or the disposition of property unquestionably that of the **sovereign**.<sup>21</sup>

### 111. NON-JUDICIAL REMEDIES — THE GENERAL ACCOUNTING OFFICE

#### A. *IN GENERAL*

The Budget and Accounting Act of 1921<sup>22</sup> established the General Accounting Office (GAO) under the supervision of the Comptroller General of the United States as an agency of the legislative branch of the Government. Creation of the GAO was the result of a continuing effort on the part of Congress to implement its constitutional powers relating to the control and expenditure of public funds.<sup>23</sup> The GAO was given duties and authority that greatly affect both the contractor and the Government in the procurement area.

#### B. *REMEDIES OF CONTRACTORS*<sup>24</sup>

The General Accounting Office has authority to settle and adjust "all claims and demands whatever by the Government of the United States or against it, and all accounts whatever in which the Government of the United States is concerned, either as debtor or creditor . . . ."<sup>25</sup> Some examples of relief granted to contractors by the Comptroller General include (1) release, because of impossibility of performance, from liability for excess costs incurred by the Government in the repurchase of **supplies**,<sup>26</sup> (2)

<sup>20</sup> *Ibid.*

<sup>21</sup> 337 U.S. at 691 n. 11.

<sup>22</sup> 42 Stat. 20 (1921), 31 U.S.C. ch. 1 and §§ 71, 471, 581, 581a (1958).

<sup>23</sup> Staff of Senate Select Committee on Small Business, 85th Cong., 2d Sess., Report on The General Accounting Office and Small Business 1 (Comm. Print 1958). See also ch. 2000, General Accounting Office, Policy and Procedures Manual for Guidance of Federal Agencies (hereinafter cited as GAO P&PM).

<sup>24</sup> For a discussion of the relief the Government may obtain through the General Accounting Office, see DA Pam 27-153, ch. 2, paras. 8-30.

<sup>25</sup> 42 Stat. 24 (1921), 31 U.S.C. § 71 (1958). 1 GAO P&PM § 3040 (1962).

<sup>26</sup> 22 Comp. Gen. 982 (1943); 20 Comp. Gen. 503 (1941).

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reformation of contracts to reflect the true intent of the parties,<sup>27</sup> and (3) adjustment for additional transportation costs.<sup>28</sup>

Whenever a contract includes a provision for liquidated damages for delay, the Comptroller General, upon recommendation of the head of the agency concerned, may remit all or part, as he considers just and equitable, of any liquidated damages assessed.<sup>29</sup> When a claim is filed with the General Accounting Office that is not subject to lawful adjustment, but which in the judgment of the Comptroller General is deserving of consideration by Congress, he shall submit it to Congress with his recommendation.<sup>30</sup>

Thus, in addition to any remedy he may have in court, a contractor has been given additional remedies before the General Accounting Office. Generally, whether a contractor uses this remedy is discretionary with him, although in some instances Congress has made using it a prerequisite to court action.<sup>31</sup> There are, however, several factors a contractor should consider before deciding whether to file suit directly or to present his claim first in the General Accounting Office. Relief from the Comptroller General will probably be obtained more expeditiously. An unfavorable decision by the Comptroller General does not preclude seeking relief in a court.<sup>32</sup> However, the General Accounting Office will not consider a claim that has been denied by a court of competent jurisdiction.<sup>33</sup>

However, when there is a conflict between the statement of a claimant and the report of the administrative agency concerned, it is an established rule of the General Accounting Office to accept the latter, in absence of evidence sufficiently convincing to overcome the presumption of the correctness thereof.<sup>34</sup> Also, a contrac-

<sup>27</sup> 20 Comp. Gen. 782 (1941); Ms. Comp. Gen. B-142022 (March 2, 1960). Generally, a price adjustment may not exceed the amount of the next lowest bid. 37 Comp. Gen. 398 (1957); Ms. Comp. Gen. B-142022 (March 2, 1960). But, if it is apparent the next lowest bid is also erroneous, the contract price may be adjusted to the next lowest correct bid. Ms. Comp. Gen. B-129184 (Oct. 3, 1956); see also C. N. Monroe Manufacturing Co. v. United States, 143 F.Supp. 449 (E.D. Mich. 1956), digested in U.S. Dep't of Army, Pamphlet No. 715-50-1, Mistake Alleged After Award para. 15 (1957) (Procurement Legal Service) (hereinafter cited as DA Pam 715-50-1). Relief will not be granted from a mutual mistake of law. 23 Comp. Gen. 957 (1944).

<sup>28</sup> 32 Comp. Gen. 466 (1953).

<sup>29</sup> 10 U.S.C. § 2312 (1958); 64 Stat. 591 (1950), 41 U.S.C. § 256a (1958). This authority is not intended to be exercised in the absence of substantial equities in favor of the contractor. 36 Comp. Gen. 143 (1956).

<sup>30</sup> 45 Stat. 413 (1928), 31 U.S.C. § 236 (1958).

<sup>31</sup> Congress has so required in the case of a claim for credit under 28 U.S.C. § 2406 (1958).

<sup>32</sup> *Belcher v. United States*, 94 Ct. Cl. 137 (1941); *McCabe v. United States*, 84 Ct. Cl. 291, 293 (1936).

<sup>33</sup> 30 Comp. Gen. 178 (1950).

<sup>34</sup> 37 Comp. Gen. 568 (1958).

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tor having a claim must bear in mind that, in general, suits must be filed in the courts within 6 years after a cause of action **arises**,<sup>35</sup> but may be filed in the General Accounting Office up to 10 years from such **time**.<sup>36</sup> In a case where the 6-year period is about to expire, it would be wise for the contractor to commence suit in an appropriate court in order to keep his judicial remedy available. A contractor may file suit in a court even though he has a claim pending in the General Accounting Office and, conversely, may submit a claim to the General Accounting Office even though he has filed **suit**.<sup>37</sup>

A claim of a contractor may be submitted to the General Accounting Office by an administrative agency, because balances certified by the General Accounting Office, upon the settlement of public accounts, are final and conclusive upon the Executive Branch of the Government.<sup>38</sup> Disbursing officers, or the head of any executive department, or other establishment not under any of the executive departments, may apply for a decision of the Comptroller General upon any question to be decided under them.<sup>39</sup>

### C. PROCEDURE FOR FILING CLAIMS

Contractors may submit a claim individually or through an attorney or other recognized representative.<sup>40</sup> Generally, no particular form is required for filing a claim, but it must be presented in writing over the signature and address of the claimant or over the signature of the claimant's authorized agent or attorney.<sup>41</sup> To expedite handling, claims should be initially filed with the agency out of whose activities they arose.<sup>42</sup> However, if the statutory period of limitation is soon to expire, claims should be

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<sup>35</sup> 28 U.S.C. §§ 2401, 2501 (1958).

<sup>36</sup> 54 Stat. 1061 (1940), 31 U.S.C. § 71a (1958) (the section is also printed as 31 U.S.C. § 237).

<sup>37</sup> Staff of Senate Select Committee on Small Business, 87th Cong., 1st Sess., A Primer on Government Contract Claims 4-5 (Comm. Print 1961).

<sup>38</sup> 3842 Stat. 24 (1921), as amended, 31 U.S.C. § 74 (1958). For a discussion of the role of the GAO in the fiscal administration of the Government, see DA Pam 27-163, ch. 2, para. 7.

<sup>39</sup> This decision when rendered shall be binding on the GAO in passing on the account containing the disbursement. 42 Stat. 24 (1921), as amended, 31 U.S.C. § 74 (1958). However, for a decision to be binding, all material facts must be submitted with the questioned payment. 20 Comp. Gen. 759 (1941).

<sup>40</sup> 1 GAO P&PM § 5020.10 (1962). A person other than an attorney is required to submit an application for enrollment to the General Counsel, General Accounting Office, 1 GAO P&PM § 5020.20 (1962).

<sup>41</sup> 4 GAO P&PM § 2020.10 (1958). It is important to fulfill this requirement in order to toll the statute of limitations. Ms. Comp. Gen. B-142365 (April 12, 1960).

<sup>42</sup> 4 GAO P&PM § 2020.30 (1958).

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submitted directly to the Claims Division, General Accounting Office, Washington 25, D. C.43

Although there is no requirement that a claimant be given a formal hearing before the General Accounting Office,<sup>44</sup> requests for personal interviews are generally **granted**,<sup>45</sup> but any additional evidence must be submitted in writing before it will be considered in settlement of the claim.<sup>46</sup> In cases where the General Accounting Office has denied a claim in whole or in part, the claimant may request a review by the Comptroller General.<sup>47</sup> Applications for review of claim settlements should state the errors that the applicant believes have been **made**.<sup>48</sup>

### IV. NON-JUDICIAL REMEDIES: CONTRACTUAL REMEDIES

#### A. *IN GENERAL*

In addition to having the judicial and non-judicial remedies granted by statute, the government contractor normally has a contractual remedy. This remedy is provided by the use in government contracts of a clause stating that the contracting officer shall decide disputed questions of fact, subject to the contractor's appeal to the Secretary of the department or his duly authorized representative.

#### B. *THE DISPUTES CLAUSE*

The Disputes Clause prescribed for supply contracts of the military departments <sup>49</sup> provides :

<sup>43</sup> 4 GAO P&PM § 2025.10 (1958).

<sup>44</sup> 21 Comp. Gen. 244 (1941).

<sup>45</sup> Staff of Senate Select Committee on Small Business, 87th Cong., 1st Sess., A Primer on Government Contract Claims 5 (Comm. Print 1961).

<sup>46</sup> 4 GAO P&PM § 2040.10 (1958).

<sup>47</sup> 22 Comp. Gen. 821 (1943); 4 GAO P&PM § 2065.10 (1958).

<sup>48</sup> 4 GAO P&PM § 2065.20 (1958).

<sup>49</sup> Armed Services Procurement Reg. para. 7-103.12(a) (July 1, 1960) (hereinafter referred to and cited as ASPR). (Unless the contrary is indicated, all citations to ASPR are to the July 1, 1960 edition.) This clause is included in the 1961 edition of the standard government supply contract form, Cl. 12, SF 32 (Sept. 1961 ed.), set out in Federal Procurement Regulation § 1-16.901-32 (Oct. 1961). The clause used in the latest standard government construction contract form, Cl. 6, SF 23A (April 1961 ed.), has been modified to paraphrase the Wunderlich Act, 68 Stat. 81 (1954), 41 U.S.C. §§ 321-22 (1958), as follows:

(a) . . . . The decision of the head of the agency or his duly authorized representative for the determination of such appeals shall be final and conclusive. This provision shall not be pleaded in any suit involving a question of fact arising under this contract as limiting judicial review of any such decision to cases where fraud by such official or his representative

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(a) Except as otherwise provided in this contract, any dispute concerning a question of fact arising under this contract which is not disposed of by agreement shall be decided by the Contracting Officer, who shall reduce his decision to writing and mail or otherwise furnish a copy thereof to the Contractor. The decision of the Contracting Office shall be final and conclusive unless, within 30 days from the date of receipt of such copy, the Contractor mails or otherwise furnishes to the Contracting Officer a written appeal addressed to the Secretary. The decision of the Secretary or his duly authorized representative for the determination of such appeals shall be final and conclusive unless determined by a court of competent jurisdiction to have been fraudulent, or capricious, or arbitrary, or so grossly erroneous as necessarily to imply bad faith, or not supported by substantial evidence. In connection with any appeal proceeding under this clause, the Contractor shall be afforded an opportunity to be heard and to offer evidence in support of his appeal. Pending final decision of a dispute hereunder, the Contractor shall proceed diligently with the performance of the contract and in accordance with the Contracting Officer's decision.

(b) This 'Disputes' clause does not preclude consideration of law questions in connection with decisions provided for in paragraph (a) above; *provided*, that nothing in this contract shall be construed as making final the decision of any administrative official, representative, or board on a question of law.

### 1. *Historical Background*

Although the courts early upheld clauses authorizing a government official to decide unilaterally, with or without provision for appeal to higher authority, a disputed question under a contract,<sup>50</sup> for a time there was some question about the extent to which these administrative determinations were binding on the courts. For example, the Court of Claims once took the view that the parties could not agree that any administrative decision would be final on questions of law, for such an agreement would, in effect, usurp the jurisdiction given the Court of Claims by Congress to determine claims founded upon any contract with the

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or board is alleged: *Provided, however*, that any such decision shall be final and conclusive unless the same is fraudulent or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith or is not supported by substantial evidence. . . .

<sup>50</sup> *Kihlberg v. United States*, 97 U.S. 398 (1878) (In a contract providing for transportation of government stores and supplies, the parties agreed that ascertainment and fixing of distances upon which payment would be based would be by the Chief Quartermaster of the District of New Mexico). See also *Ripley v. United States*, 223 U.S. 695 (1912). For a case where the Supreme Court earlier recognized the decision of a board of commissioners appointed by the Secretary of War to determine the amount due a contractor who voluntarily submitted his claim to that board, see *United States v. Adams*, 74 U.S. (7 Wall.) 463 (1868). In *United States v. Barlow*, 184 U.S. 123 (1902), the contract provided that the decision of an administrative officer was final subject only to appeal to the Secretary. The Supreme Court, however, did not find it necessary to consider the validity of this provision in their determination of the case.

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United States.<sup>51</sup> This position of the Court of Claims, however, was overturned by the Supreme Court in *United States v. Moorman*.<sup>52</sup>

As to finality of administrative decisions on questions of fact, the Supreme Court stated in *Kihlberg v. United States*<sup>53</sup> that such decisions would be final and conclusive "in the absence of fraud or such gross mistake as would necessarily imply bad faith, or a failure to exercise an honest judgment" in the premises. The Court of Claims expanded this exception to include "arbitrary" or "capricious" conduct and stated that unless a decision is "supported by substantial evidence, it must be treated as having been arbitrary, capricious, or so grossly erroneous as to imply bad faith, and therefore, lacking in finality."<sup>54</sup> However, this expansion of judicial review was halted temporarily, by the Supreme Court's holding in *United States v. Wunderlich*<sup>55</sup> that a final decision under a disputes clause was conclusive unless actual fraud were alleged and proved. The Court defines "fraud" as "conscious wrongdoing, an intention to cheat or be dishonest." The contractor's right to judicial review of decisions under a disputes clause thus became extremely limited. Absent fraud, such a decision was undoubtedly final on a question of fact<sup>56</sup> and probably final on a question of law.<sup>57</sup> In the latter case, of course, the disputes clause would have to provide for such finality.

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<sup>51</sup> *E.g.*, *Beuttas v. United States*, 101 Ct. Cl. 748 (1940) (wherein the question was whether the United States had breached the contract), *rev'd on other grounds*, 324 U.S. 768 (1954); *Davis v. United States*, 82 Ct. Cl. 334 (1936). At least one of the circuit courts of appeals expressed the same view. *S. J. Groves & Sons Co. v. Warren*, 135 F.2d 264 (D.C. Cir. 1943), *cert. denied*, 319 U.S. 766 (1943). For subsequent litigation involving the same claim see *S. J. Groves & Sons Co. v. United States*, 106 Ct. Cl. 93 (1946) where the Court of Claims did not pass on this issue.

<sup>52</sup> 338 U.S. 457 (1950). Actually, some years earlier the Supreme Court had disagreed with the view of the Court of Claims when it summarily reversed a Court of Claims judgment, *John McShain, Inc. v. United States*, 88 Ct. Cl. 284 (1939), that was based on the proposition that these administrative decisions could not be final on a question of law. *United States v. John McShain*, 308 U.S. 512 (1939).

<sup>53</sup> 97 U.S. 398 (1878).

<sup>54</sup> *Wagner, Whirler & Derrick Corp. v. United States*, 128 Ct. Cl. 382, 386 (1954). *Cf. Penner Installation Corp. v. United States*, 116 Ct. Cl. 550 (1950), *aff'd by equally divided court*, 340 U.S. 898 (1950); *Loftis v. United States*, 110 Ct. Cl. 551 (1948); *Needles v. United States*, 101 Ct. Cl. 535 (1944). There is indication that at one time the Supreme Court was sympathetic to this view of the Court of Claims. See *Ripley v. United States*, 223 U.S. 695 (1912).

<sup>55</sup> 342 U.S. 98 (1951).

<sup>56</sup> The *Wunderlich* case involved a fact type clause. The Court of Claims was quick to apply the strict standard set by the *Wunderlich* case. *Palace Corp. v. United States*, 124 Ct. Cl. 545 (1953), *cert. denied*, 346 U.S. 815 (1953).

<sup>57</sup> At least one court took this view. *Wildermuth v. United States*, 195 F.2d 18 (7th Cir. 1952). The disputes clause in the contract involved in th's case provided for administrative finality on "all" disputes.

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The narrow scope of judicial review brought about by the *Wunderlich* case was short lived. Pursuant to demands from sources in both industry and Government,<sup>58</sup> Congress passed the Act of May 11, 1954,<sup>59</sup> popularly known as the Wunderlich Act, because it was designed to overcome the effect of the *Wunderlich* decision.<sup>60</sup> The Act provides :

1. No provision of any contract entered into by the United States, relating to the finality or conclusiveness of any decision of the head of any department or agency or his duly authorized representative or board in a dispute involving a question arising under such contract shall be pleaded in any suit now filed or to be filed as limiting judicial review of any such decision to cases where fraud by such official or his said representative or board is alleged: Provided, however, That any such decision shall be final and conclusive unless the same is fraudulent or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence.

2. No Government contract shall contain a provision making final on a question of law the decision of any administrative official, representative, or board.<sup>61</sup>

The main effect of the Wunderlich Act was to restore the standard of review followed by the Court of Claims prior to the Supreme Court decision in the *Wunderlich*<sup>62</sup> case and to broaden it by the addition of the "substantial evidence" test.<sup>63</sup> In addition, the Wunderlich Act prevented the use of clauses allowing administrative decisions on questions of law to be final.

Before examining the actual extent of the judicial review of these administrative decisions, however, an understanding of the actual administration of this dispute procedure within an agency is desirable. Although other federal agencies have established procedures for processing contractual disputes, the military departments have processed more disputes over a longer period of time than any other department. Accordingly, the disputes procedure of the military departments will be considered in this article.

### 2. *The Disputes Procedure: The Contracting Officer's Decision*

*The decision must be that of the contracting officer.* A dispute begins when a disagreement arises between the contractor and the contracting officer. The preferred method of settling the dispute is by agreement between the parties. If they fail to agree, the first

<sup>58</sup> H.R. Rep. No. 1380, 83d Cong., 2d Sess. (1954), in 2 U.S. Code Cong. & Ad. News, 83d Cong., 2d Sess. 2191 (1954).

<sup>59</sup> 68 Stat. 81 (1954), 41 U.S.C. §§ 321-22 (1958).

<sup>60</sup> H.R. Rep. No. 1380, 83d Cong., 2d Sess. (1954), in 2 U.S. Code Cong. & Ad. News, 83d Cong., 2d Sess. 2191 (1954).

<sup>61</sup> The standard Department of Defense Disputes Clause set out earlier in this article is designed to comply with this Act.

<sup>62</sup> 342 U.S. 38 (1951).

<sup>63</sup> *Volentine and Littleton v. United States*, 136 Ct. Cl. 638, 145 F.Supp. 952 (1952).

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step in the disputes procedure prescribed by the clause is for the contracting officer to decide the dispute unilaterally. Before he does *so*, however, he should give the contractor a chance to **explain**.<sup>64</sup> The contractor is entitled to the personal and independent consideration of the contracting officer. The decision must be the contracting officer's own; if it is made or directed by another, it will not be considered a decision under the Disputes Clause.<sup>65</sup> For example, in *Climatic Rainwear Co. v. United States*<sup>66</sup> the Court of Claims stated that the contracting officer could not rely on someone in his legal department to prepare a decision under the Disputes Clause for him. However, a contracting officer is not prohibited from seeking such legal and technical advice as is available to him, so long as the final decision is his **own**.<sup>67</sup>

*Who is the contracting officer?* The clause currently prescribed for Department of Defense contracts states :

(b) the term 'Contracting Officer' means the person executing this contract on behalf of the Government, and any other officer or civilian employee who is a properly designated Contracting Officer; and the term includes, except **as** otherwise provided in this contract, the authorized representative of a Contracting Officer acting within the limits of his authority.<sup>68</sup>

In the *Climatic Rainwear* case the contract's definition of a contracting officer did not include anyone other than the officer named in the contract, nor was any successor contracting officer appointed. Therefore, the court left undecided the question whether, if there had been a definition such as set out above, another person such as the contracting officer's commanding officer, who also was an appointed contracting officer, could render a valid decision under the Disputes Clause. Although this point

<sup>64</sup> "We have always thought it takes two to make a dispute." *Keystone Coat & Apron Mfg. Corp. v. United States* (Ct. Cl. No. 524-56, June 8, 1960). "A dispute concerning the termination of the contract does not occur merely upon termination by the contracting officer if such act has not been the subject of discussion between the parties prior thereto." *Esmond Chemical Co., ASBCA No. 938* (Sept. 12, 1952).

<sup>65</sup> *John A. Johnson Contracting Corp. v. United States*, 132 Ct. Cl. 645 (1955); *Climatic Rainwear Co. v. United States*, 115 Ct. Cl. 520, 88 F.Supp. 415 (1950); *JAGT 1955/4450* (April 28, 1955), digested in DA Pam 715-50-1, Contracting Officer para. 11 (1957). (JAGT is the office symbol of the Procurement Law Division of the Office of the Judge Advocate General of the Army, which division renders extensive opinions in the area of procurement law.)

<sup>66</sup> 115 Ct. Cl. 520, 88 F.Supp. 415 (1950).

<sup>67</sup> In this connection, Army Procurement Procedure para. 7-103.12b(2) (c) (June 22, 1961) (hereinafter cited as APP) provides: "It is emphasized that, where a contract provides for a decision or a determination to be made by a contracting officer, he must give his personal and independent consideration to the making of each determination or decision, with the aid of such technical and legal advice as may be available to him."

<sup>68</sup> ASPR 7-103.1.

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does not appear to have been **litigated**,<sup>69</sup> the better practice would seem to be to have the decision made by the contracting officer actually administering the contract. The contractor should be able to look to one individual to administer the contract and make the specified determinations ; otherwise, the contractor would not know with whom he was dealing.” Of course, as a matter of necessity, quite often more than one contracting officer may administer a contract. For example, because of personnel changes, it may be necessary to appoint a successor contracting officer. Departmental procedures may divide responsibility on the same contract among several contracting officers,<sup>71</sup> provide that decisions on certain questions may be decided by someone other than the contracting officer,<sup>72</sup> or make the contracting officer’s decision subject to review.<sup>73</sup> Of course, if a decision is to be made by other than the contracting officer or is to be subject to review, the contract should so provide.

**Form of decision.** The Disputes Clause requires the contracting officer to reduce his decision to writing and to mail or otherwise furnish a copy thereof to the contractor. The Armed Services Procurement Regulation provides that the decision must specifically advise the contractor that it is final, that it is being made pursuant to the Disputes Clause, and that the contractor has a right to appeal the decision.<sup>74</sup> If the contractor is not so advised,

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<sup>69</sup> However, the Court of Claims in *Climatic Rainwear, Inc. v. United States*, 115 Ct. Cl. 520, 558, 88 F.Supp. 415, 420-21 (1950), indicated a clause like that quoted in the text at note 68 would make a difference. After noting that in the contract wherein someone other than a contracting officer had made a decision purportedly under the disputes clause there was no definition of a contracting officer, the court stated as to that contract: “No one other than Capt. E. R. Calloway had been designated in Contract 20481 as the Contracting Officer” and then : “Contract 14952, on the other hand, contained entirely different language on this point, wherein ‘Contracting Officer’ was defined to include any and all Contracting Officers, acting within the scope of the orders appointing them Contracting Officers and their duly appointed successors or representatives.” Another point that does not appear to have been litigated is, assuming a decision is forced on a contracting officer, would that make a decision an improper one even if it were correct?

<sup>70</sup> JAGT 1955/4450 (April 28, 1955), digested in DA Pam 715-50-1, Contracting Officer para. 11 (1957).

<sup>71</sup> For example, the Air Force has Administrative Contracting Officers, Procuring Contracting Officers, and Termination Contracting Officers. Air Force Procurement Instructions paras. 8-101.50, 8-101.55, and 8-101.61, in 3 Gov’t Cont. Rep. paras. 47,059, 47,064, and 47,070 (May 16, 1961).

<sup>72</sup> For example, questions of allowable costs in Navy cost-reimbursable contracts are decided initially by an auditor. Navy Procurement Directives para. 7-203.12(a) (Aug. 20, 1959).

<sup>73</sup> See, for example, the review by Settlement Review Boards of proposed settlements in cases of contract termination. ASPR 8-211.2a (Jan. 31, 1961); Termination for Convenience Clause in ASPR 8-701 (Jan. 31, 1961).

<sup>74</sup> ASPR 1-314 (Oct. 3, 1960).

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the decision of the contracting officer may not be considered final even if the contractor doesn't appeal within the prescribed time.<sup>75</sup> In addition, the contracting officer must notify the contractor of the Optional Accelerated Procedure of the Armed Services Board of Contract Appeals in appeals involving \$5,000 or less.<sup>76</sup>

*Appeal within 30 days.* If the contractor is dissatisfied with the decision of the contracting officer, and the decision is a proper one for determination by the contracting officer under the Disputes Clause, the contractor must exercise his right to appeal within 30 days or the contracting officer's decision becomes final. In computing this 30 day period the date of the receipt of the decision by the contractor is excluded.<sup>77</sup> If the last day falls on a Sunday or holiday the period for appeal is extended to the next day, but no extension is made if the last day is a Saturday and not a holiday.<sup>78</sup> However, under the Disputes Clause all that is needed to stop the running of the 30 days is for the contractor to mail the appeal.

In considering the 30 day period for filing appeals pursuant to the Disputes Clause, contractors and government procurement officials should bear in mind that other time limitations in the contract may affect the parties' rights. There is, for example, a 30 day limitation for submitting a claim under the Changes Clause.<sup>79</sup> A contractor must submit his termination claim within one year of the effective date of termination.<sup>80</sup>

*Form of appeal.* The Disputes Clause provides that the appeal mailed or furnished to the contracting officer must be in writing

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<sup>75</sup> The Court of Claims has held that a contracting officer's letter that did not comply with an Army Procurement Procedure rule similar to the ASPR provision cited in note 74 could not be considered to be a final decision of the contracting officer. *Bostwick-Batterson Co. v. United States*, 283 F.2d 956 (Ct. Cl. 1960), digested in DA Pam 715-50-74, § 11, para. 10 (1961). Also see *Curtiss-Wright Corp.*, ASBCA No. 6275 (Nov. 30, 1960), 61-1 BCA para. 2861; *Wood of Texas Industries*, ASBCA No. 5697 (Dec. 23, 1959), 59-2 BCA para. 2464, digested in DA Pam 715-50-61, § 11, para. 7 (1960); *Roy K. Hubbard*, ASBCA No. 7817 (May 21, 1962).

<sup>76</sup> ASPR 1-314 (Oct. 3, 1960).

<sup>77</sup> *Schroeder Tool & Engineering Co.*, ASBCA No. 851 (Feb. 5, 1952).

<sup>78</sup> *Lormar Instrument Co.*, ASBCA No. 3297 (April 2, 1957), 57-1 BCA para. 1228.

<sup>79</sup> See, e.g., the January 1958 edition of the Changes Clause for fixed-price supply contracts. ASPR 7-103.2. The 30 day limitation in that clause may be extended by the contracting officer.

<sup>80</sup> See, e.g., the January 1961 edition of the Termination for Convenience of the Government Clause for fixed-price contracts. ASPR 8-701 (Jan. 31, 1961). The time limit in that clause may also be extended by the contracting officer.

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and addressed to the Secretary of the department concerned.<sup>81</sup> The rules of the Armed Services Board of Contract Appeals provide:

A notice of appeal should indicate that an appeal is thereby intended, and should identify the contract (by number), the department and agency or bureau cognizant of the dispute, and the decision from which the appeal is taken. The notice of appeal should be signed personally by the appellant (the Contractor making the appeal), or by an officer of the appellant corporation or member of the appellant firm, or by the Contractor's duly authorized representative or attorney. . . .<sup>82</sup>

This requirement that the appeal state that it is an appeal is a very important one. Although the Board has been extremely liberal in some cases in finding that a letter sent to a contracting officer within 30 days of his decision indicated an intent to appeal and, therefore, was a timely **appeal**,<sup>83</sup> there have been cases where the Board has found otherwise.<sup>84</sup> Therefore, a contractor should explicitly state he is appealing.

**Finality of the contracting officer's decision.** As stated above, the Disputes Clause provides that unless the contractor does appeal within 30 days from the contracting officer's decision, that decision is "final and conclusive." The Armed Services Board of Contract Appeals has held this 30 day appeal period to be jurisdictional. For example, in *Victor Products Corporation*<sup>85</sup> the ASBCA stated :

The Board has held in innumerable cases that unless the appellant effects an appeal within the 30 day period specified in the 'Disputes' article, this Board is without authority to consider the matter. At the expiration of the 30 day period the Government has acquired rights which cannot be waived by the Secretary or by this Board.

The contracting officer may not revive the right to appeal by reconsidering the contractor's claim after the 30 day period has expired.<sup>86</sup> However, the contracting officer may reconsider his decision within the 30 day period<sup>87</sup> and if he does so, the con-

<sup>81</sup> The ASBCA has held that addressing an appeal to the Secretary is not required, that filing the appeal with the contracting officer is sufficient. *New York Engineering Co.*, ASBCA No. 289 (April 13, 1950). The ASBCA rules so provide. ASPR, Appendix A, Rule 2.

<sup>82</sup> ASPR, Appendix A, Rule 3.

<sup>83</sup> For example, in *New York Engineering Company*, ASBCA No. 289 (April 13, 1950), the Board held that a letter indicating an intent by the contractor to treat the contract as breached by the Government was actually an appeal.

<sup>84</sup> *E.g.*, *Reading Clothing Manufacturing Company*, ASBCA No. 3912 (May 7, 1957), 57-1 BCA para. 1290. In that case the Board discusses several earlier decisions holding there was an intent to appeal and several where there was not.

<sup>85</sup> ASBCA No. 4911 (June 24, 1958), 58-2 BCA para. 1844.

<sup>86</sup> *McGraw-Hill Book Co.*, ASBCA No. 4500 (July 7, 1958), 58-2 BCA para. 1858.

<sup>87</sup> *Chemical Service Corporation*, ASBCA No. 734 (Jan. 2, 1951).

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tractor will have **30** days to appeal after receipt of the contracting officer's decision after reconsideration.<sup>88</sup> Because of the wording of the Default Clause<sup>89</sup> in defense contracts, a peculiar rule has developed where a contract has been terminated for default. The contractor may have the issue of excusability of his default determined on an appeal from an assessment of excess costs, even though he did not submit a timely appeal from the default termination itself.<sup>90</sup> However, a contracting officer's decision on any issue other than excusability, for example a decision that the contractor failed to deliver supplies meeting the contract specifications, is final unless the contractor appeals within **30** days of the decision. If the contractor does not timely appeal, those questions may not be reopened in an appeal from the assessment of excess costs.<sup>91</sup>

If he fails to submit a timely appeal from a contracting officer's decision, a contractor may not obtain relief from the courts, for they will hold he has failed to exhaust his administrative remedies.<sup>92</sup> Of course, the contracting officer's decision does not preclude the courts from giving a contractor relief if that decision pertains to a matter not within the purview of the Disputes Clause. Examples are: whether a contractor offered or gave any gratuities to any officer or employee of the Government with a view toward securing a contract or favorable treatment,<sup>93</sup> and where the contracting officer's action has in effect breached the contract.<sup>94</sup> Moreover, under the Disputes Clause an unappealed decision of a contracting officer on a question of law is not final.<sup>95</sup> However, it seems that his unappealed decision would be final on a question of fact and not reviewable by the courts even if it were not based on substantial evidence. The provision in the Wunder-

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<sup>88</sup> Union Sewing Machine Company, ASBCA No. 4796 (Feb. 26, 1959), 59-1 BCA para. 2121, digested in DA Pam 715-50-2, Disputes para. 40 (1960).

<sup>89</sup> See, *e.g.*, the November 1961 edition of the Default Clause for fixed-price supply contracts. ASPR 8-707 (Nov. 15, 1961).

<sup>90</sup> Fulford Mfg. Co., ASBCA Nos. 2143, 2144 (May 20, 1955), digested in DA Pam 715-50-1, Default para. 70 (1957).

<sup>91</sup> Virginia Dare Extract Co., ASBCA No. 4916 (April 24, 1959), 59-1 BCA para. 2188, digested in DA Pam 715-50-2, Default para. 64 (1960).

<sup>92</sup> United States v. Callahan Walker Constr. Co., 317 U.S. 56 (1942); *Happel v. United States*, 279 F.2d 88 (8th Cir. 1960).

<sup>93</sup> See the Gratuities Clause (March 1952), ASPR 7-104.16 (Aug. 21, 1961).

<sup>94</sup> See, *e.g.*, *Saddler v. United States*, 287 F.2d 411 (Ct. Cl. 1961) (change beyond scope of the contract constitutes a breach of contract).

<sup>95</sup> The disputes clauses for both the supply and construction contracts explicitly follow the requirement of 68 Stat. 81 (1954), 41 U.S.C. § 322 (1958), that "No Government contract shall contain a provision making final on a question of law the decision of any administrative official, representative, or board." Cl. 12, SF 32 (Sept. 1961 ed.), quoted in text at note 49; Cl. 6, SF 23A (April 1961 ed.), quoted in note 49.

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lich Act <sup>96</sup> preventing such a decision from being final applies only to decisions of "the head of any department or agency or his duly authorized representative or board."

### *3. The Disputes Procedure: The Armed Services Board of Contract Appeals*

Unless the Disputes Clause of a contract provides for an intermediate appeal,<sup>97</sup> the appeal is to the Secretary of the Department. The Armed Services Board of Contract Appeals has been designated the authorized representative of the Secretary of Defense and the Secretaries of the Military Departments to consider and determine appeals under the Disputes Clause.<sup>98</sup>

*Jurisdiction is appellate.* The Board's jurisdiction is appellate; that is, there must be a contracting officer's decision from which the contractor has appealed. An appeal will usually be dismissed or remanded to the contracting officer as to any issues on which he has not made a decision.<sup>99</sup> However, the refusal of a contracting officer to consider a claim or to render a decision on it may itself

<sup>96</sup> 68 Stat. 81 (1954), 41 U.S.C. § 321 (1958).

<sup>97</sup> Although ASPR 7-103.12 (July 22, 1960) authorizes amending the Disputes Clause to provide for intermediate appeal to the Head of the Procuring Activity concerned, by Memorandum dated March 6, 1962, the Deputy Secretary of Defense requested that the function of any board of contract appeals exercising intermediate appellate jurisdiction, except those boards located in overseas areas, be eliminated as soon as practicable. Prior to this it had been the practice in Army Engineer construction contracts to provide for an intermediate appeal to the Chief of Engineers who had designated a board to hear these appeals. Engineer Contract Instructions para. 7-603.1c (Aug 30, 1961) (hereinafter cited as ECI) and ECI 51-103 (April 24, 1959). That Board's decision was final unless the contractor appealed within 30 days to the Secretary of the Army. ECI 7-603.1c (Aug. 30, 1961). In civil works contracts the decision of the Chief of Engineers or his designated representative is final (ECI 51-102 (Jan. 1, 1959)) by virtue of a delegation of authority to the Chief of Engineers by the Secretary of War on March 4, 1937 (ECI 51-102 (Jan. 1, 1959)). The disputes clause used by major Army overseas commands provides for an intermediate appeal to the commanding general of the command; his decision, or that of his duly authorized representative, is final when the amount involved is \$50,000 or less. Where the amount in dispute is more than \$50,000, the contractor may take a further appeal to the Secretary of the Army. See, e.g., USAREUR Procurement Procedure para. 7-103.11 (Sept. 1, 1961); TEKS Insaat ve Senayi Ltd., ASBCA No. 7397 (Nov. 24, 1961), 61-2 BCA para. 3224. The Air Force disputes clause for use in certain overseas areas provides for a final decision to be made by the commander or his authorized representative in appeals involving \$25,000 or less. In appeals involving more than \$25,000, the contractor's appeal from the contracting officer's decision is directly to the Secretary of the Air Force, with no intermediate appeal. Air Force Procurement Instruction para. 7-4205.8, in 3 Gov't Cont. Rep. para. 46,590 (April 11, 1961).

<sup>98</sup> Dep't of Defense Directive No. 5154.17 (March 20, 1962).

<sup>99</sup> Hesse-Eastern Corp., ASBCA No. 1832 (March 10, 1954), digested in DA Pam 715-50-1, Allowable Costs para. 7 (1957); Atlas Fabrics Corp., ASBCA No. 6286 (Jan. 15, 1962), 1962 BCA para. 3264.

be an appealable **decision**,<sup>100</sup> and a contracting officer may not oust the Board of jurisdiction by attempting to withdraw a decision from which an appeal has been **filed**.<sup>101</sup> In an appeal by a contractor from a decision unfavorable to him in part, the Government may challenge the part favorable to the contractor.<sup>102</sup>

*Questions of law.* Obviously, under the current Disputes Clause, decisions of the ASBCA on questions of law are not conclusive, nor could they be made so after the passage of the Wunderlich Act. However, does the clause give the Board any jurisdiction over a question of law in the first place? The clause states it applies to **disputes** concerning questions of fact arising under the contract, but there are many cases in which questions of fact and law are mixed to such an extent that they cannot be considered independently. This is recognized by part (b) of the clause, which provides that the clause does not preclude consideration of law questions in connection with decisions involving disputed **facts**.<sup>103</sup> But what about pure questions of law, assuming they exist?

This problem concerned the War Department Board of Contract Appeals, a predecessor of the Armed Services Board of Contract Appeals, for some years, until a memorandum of the Secretary of War was issued on July 4, 1944. This memorandum gave the War Department Board of Contract Appeals such authority and discretion as the Secretary of War himself might exercise either through contractual power or otherwise in the consideration and disposition of appeals.<sup>104</sup> Immediately thereafter, the Board seized upon this memorandum as granting it authority to determine pure questions of **law**.<sup>105</sup> Then in 1949 this board, now

<sup>100</sup> Aerodex, Inc., ASBCA No. 6546 (July 25, 1961), 61-2 BCA para. 3113; Wood of Texas Industries, ASBCA No. 5697 (Dec. 23, 1959), 59-2 BCA para. 2464.

<sup>101</sup> Parkside Clothes, Inc., ASBCA No. 4184 (July 1, 1960), 60-2 BCA para. 2707; Pace Corp., ASBCA No. 5954 (June 30, 1960), 60-2 BCA para. 2698.

<sup>102</sup> Russell B. Gannon Co., ASBCA Nos. 1199 and 1388 (Dec. 14, 1953), digested in DA Pam 715-50-1, Allowable Costs para. 6 (1957); JAGT 1954/1271 (Jan. 22, 1954), digested in DA Pam 715-50-1, Disputes para. 47 (1957).

<sup>103</sup> An early ASBCA case applied part of the Board's charter to the same effect. Silas Mason Co., ASBCA No. 234 (Dec. 16, 1949).

<sup>104</sup> The memorandum is quoted in full in Forest Box & Lumber Co., ASBCA No. 2916 (Feb. 6, 1956). In commenting on the memorandum, the Court of Claims has stated: "It is evident that the Secretary was authorizing the Board to act for him in the way that any owner would act if a contractor was dissatisfied with the way he was treated by the owner's representative in charge. He would listen to the contractor's story, and if he thought that his representative had been unfair, he would reverse him. He would do this, not because the contract gave him any authority to make a final decision which would bar the contractor from relief in the courts for breach of contract, but because it would be the natural and fair way for an owner to act." *McWilliams Dredging Co. v. United States*, 118 Ct. Cl. 1, 16-17 (1950).

<sup>105</sup> Peter Kiewit Sons, WD BCA No. 717 (July 18, 1944). For discussion of the early decisions in this area, see Austin, *Digest of Decisions*, Army Board of Contract Appeals 1942-50: Interpretation, Jurisdictional Questions.

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called the Army Board of Contract Appeals, and the Navy Board of Contract Appeals were absorbed into the Armed Services Board of Contract Appeals, which, as originally constituted, was divided into three panels, designated the Army, Navy, and Air Force Contract Appeals Panels, each of which generally decided the disputes arising in the contracts of their own services.<sup>106</sup> Both the Army and Air Force panels took jurisdiction over questions of law<sup>107</sup> but the Navy did not.<sup>108</sup> At first the Army panel based its jurisdiction on the July 4, 1944 memorandum,<sup>109</sup> but, even after that memorandum was rescinded,<sup>110</sup> the Army panel continued to exercise jurisdiction over what appeared to be pure questions of law.<sup>111</sup>

An example of the action of the Air Force panel in this area is *Aerodex, Inc.*<sup>112</sup> This case involved the interpretation of a contract and its option clause, the issue being the period of time that the parties intended the Government to have in which to exercise the option. The contracting officer refused to render a decision under the Disputes Clause on the ground that a pure question of law was involved. On appeal from the contracting officer's refusal, the Air Force panel of the ASBCA denied the Government's motion to dismiss the "purely legal question." The Air Force panel said merely that the motion lacked merit.

This panel split, which certainly could not be considered desirable, will probably soon be resolved for, effective May 1, 1962, the Armed Services Board of Contract Appeals was reorganized under a new charter which abolished the individual service panels.<sup>113</sup> This should result in a single position on this jurisdictional question.

<sup>106</sup> In certain cases disputes were decided by the full Board membership.

<sup>107</sup> *Waterman Steamship Co.*, ASBCA No. 362 (Feb. 13, 1951). Appeal, of course, had to be filed within the time allowed by the disputes clause. *Anderson Air Activities*, ASBCA No. 1463 (Feb. 15, 1954). *Aerodex, Inc.*, ASBCA No. 6546 (July 25, 1961), 61-2 BCA para. 3113.

<sup>108</sup> *Arkansas Louisiana Gas Company*, ASBCA No. 2232 (Dec. 28, 1954); *Minneapolis-Moline Co.*, ASBCA No. 1961 (June 11, 1954).

<sup>109</sup> *Waterman Steamship Co.*, ASBCA No. 362 (Feb. 13, 1951).

<sup>110</sup> JAGT 1958/8384 (Dec. 16, 1958), digested in DA Pam 715-50-2, Disputes para. 36 (1960).

<sup>111</sup> *General Motors Corp., Allison Division*, ASBCA Nos. 5206, 5207, and 5208 (April 25, 1960), 60-1 BCA para. 2614, digested in DA Pam 715-50-66, § 111, para. 7 (1960), *motion for reconsideration dismissed*, Dec. 13, 1960, 61-1 BCA para. 2880, digested in DA Pam 715-50-75, § II, para. 6 (1961). In this case, which appeared primarily to involve the interpretation of a statute, the Army panel took jurisdiction saying the issues framed were "typical of issues regularly brought before this Board for its decision." The Comptroller General agreed with the Board's interpretation of the statute. *Ms. Comp. Gen. B-143135* (April 14, 1961).

<sup>112</sup> ASBCA No. 6546 (July 25, 1961), 61-2 BCA para. 3113.

<sup>113</sup> Dep't of Defense Directive No. 5154.17 (March 20, 1962).

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**Damages for breach of contract.** The ASBCA has consistently ruled that unless there is a contract clause providing for a price adjustment for the action or inaction of the Government on which the contractor's claim is based, the Board will hold that it has no jurisdiction to grant the relief sought.<sup>114</sup> For example, in a case where the contractor sought standby costs incurred in awaiting the issuance of a change order, the Board held that the Changes Clause gives the Government the contractual right without incurring liability to delay or suspend contract performance for a reasonable period of time while exercising the right to make or consider contract changes; in the event the Government takes more than a reasonable time, claims for increased costs occasioned thereby, in absence of a contract provision providing for adjustment therefor, are in the nature of claims for damages for breach of contract over which the Board has no jurisdiction.<sup>115</sup> Similarly, the Board has stated it has no jurisdiction to compensate for increased cost in performing the unchanged work resulting from a change order unless there is a contractual provision authorizing an **adjustment**.<sup>116</sup> Similarly, where a contractor requested reimbursement for standby costs incurred as a result of failure of the Government promptly to inspect and accept pilot lots of ammunition called for by the contract, the appeal was dismissed for lack of jurisdiction because the contract contained no provision authorizing price adjustment for costs incurred

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<sup>114</sup> Rosenthal & Son, Inc., ASBCA No. 7333 (Sept. 11, 1961), 61-2 BCA para. 3150; Specialty Assembling & Packing Co., ASBCA Nos. 4523-32 (Sept. 29, 1959), 59-2 BCA para. 2370; Johnson & Cox, ASBCA No. 2300 (Jan. 27, 1956), digested in DA Pam 715-50-1, Changes para. 13 (1957). In a recent decision, however, the Board appeared to ignore this jurisdictional limitation. Tulsa Army and Navy Store, ASBCA No. 6449, *on motion for reconsideration*, (April 26, 1961), 61-1 BCA para. 3022, digested in DA Pam 715-50-90, § II, para. 3 (1962).

<sup>115</sup> Roscoe Engineering Corp. Associates, ASBCA No. 5370 (Sept. 13, 1961), 61-2 BCA para. 3148; Laburnum Constr. Corp., ASBCA No. 5525 (Aug. 10, 1959), 59-2 BCA para. 2309. For examples of clauses which, if contained in a contract, would be a basis for the Board's jurisdiction see the "Price Adjustment for Suspension, Delay or Interruption of Work" clause (Nov. 1961), ASPR 7-604.3, for use in certain construction contracts, and the "Stop Work Order" clause (July 1960), ASPR 7-105.8, for use in certain supply contracts.

<sup>116</sup> Roscoe Engineering Corp. Associates, note 115 *supra*; Laburnum Constr. Corp., note 115 *supra*. The current "Changes" clause (Jan. 1958) for fixed price supply contracts (ASPR 7-103.2, which is identical to Art. 2, Standard Form 32 (Sept. 1961 ed.)) does provide a basis for adjustment for increased costs in performing unchanged work. There is no standard provision for construction contracts that so provides.

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as a result of delays by the Government and the Changes Clause could not be made the basis for relief.<sup>117</sup>

The Board has also held it has no jurisdiction over a claim for increased costs for late delivery of property the Government has agreed to furnish unless there is a provision in the contract providing for adjustment of price in this eventuality.<sup>118</sup>

Even though the Board may not have jurisdiction over the contractor's claim, the Charter of the Board authorizes it to determine facts in such cases without expressing an opinion on the question of liability." However, the contractor has no right to demand these findings.<sup>120</sup> Where a motion to dismiss is granted before a hearing on the merits, there is little point in having these findings made. However, they would be merited where the motion was granted after a hearing had been held.

In other cases the Board may not have effective jurisdiction over an appeal or may not be able, for one reason or another, to grant the relief requested, and yet it may be desirable to have the Board render an advisory opinion on the merits. The Board has done so in cases involving the so-called Capehart Housing contracts where a contractor claims additional compensation but the

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<sup>117</sup> *Simmel-Industries Meccaniche Societa per Azioni*, ASBCA No. 6141 (Jan. 24, 1961), 61-1 BCA para. 2917. *Accord*, *Corbetta Constr. Co.*, ASBCA No. 6821 (Oct. 3, 1961), 61-2 BCA para. 3170; *Blount Bros. Constr. Co.*, ASBCA No. 6842 (April 29, 1960), 60-1 BCA para. 2634; *Crystal X Corp.*, ASBCA No. 677 (June 30, 1952). However, the ASBCA has held that an order to accelerate may create a right to an equitable adjustment under the Changes Clause. *Standard Store Equipment Co.*, ASBCA No. 4348 (Aug. 28, 1958), 58-2 BCA para. 1902. In the *Simmel-Industries* decision, *supra*, which was a decision by the chairman of the three panels (equivalent to a "full board" decision), one of the chairman dissented, saying that the time had come for the Board to recognize the fallacy of treating delay costs different from acceleration costs. He could see no difference between an order to advance production one month and an order to postpone production one month. In his dissent he cited the following cases in which he felt the Board had taken a position diametrically opposite to the one taken in *Simmel-Industries*: *Todd Shipyards Corp.*, ASBCA Nos. 649, 650 (Sept. 28, 1961); *Schaefer & Co.*, ASBCA No. 917 (Jan. 31, 1952).

<sup>118</sup> *Croft-Mullins Electric Co.*, ASBCA No. 6113 (Jan. 27, 1961), 61-1 BCA para. 2922; *Larson-Ralto Constr. Co.*, ASBCA No. 7468 (Nov. 29, 1961), 61-2 BCA para. 3245. For an example of a clause which, if contained in a contract, would be the basis for the Board's jurisdiction see the "Government-Furnished Property" clause (Nov. 1961), ASPR 13-502, for use in certain fixed-price contracts. For an interpretation of a similar provision see *Van Brode Milling Co., Inc.*, ASBCA No. 4289 (Dec. 22, 1959), 59-2 BCA para. 2456, *aff'd on reconsideration*, (March 28, 1960), 60-1 BCA para. 2597.

<sup>119</sup> Dep't of Defense Directive No. 6164.17 (March 20, 1962), which is set out in ASPR, Appendix A. This was true also of the former charter.

<sup>120</sup> *Simmel-Industries Meccaniche Societa per Azioni*, ASBCA No. 6141 (Jan. 24, 1961), 61-1 BCA para. 2917.

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Board is unable to grant the request because the statutory limitation<sup>121</sup> on the contract price has already been reached.<sup>122</sup>

**Subcontractors.** Generally, a subcontractor has no right of direct appeal to the Armed Services Board of Contract Appeals unless there is in the subcontract a clause so providing, inserted at the contracting officer's direction or specifically approved by the contracting officer.<sup>123</sup> However, a prime contractor may appeal to the Board on behalf of a subcontractor.<sup>124</sup> However, if the subcontract between the prime and subcontractor contains a clause absolving the former of liability to the latter for acts of the Government, the prime might not be able to recover.<sup>125</sup>

<sup>121</sup> The limitation is \$19,800 for an individual family unit and an average of \$16,500 per family unit per project. 63 Stat. 670 (1949), as amended, 12 U.S.C. § 1784b(b) (3)(B) (Supp. 11, 1961).

<sup>122</sup> J. W. Bateson Co., ASBCA No. 6100 (Oct. 23, 1961), 61-2 BCA para. 3184; Fort Sill Associates, ASBCA Nos. 7482, 7925 (June 26, 1962), 1962 BCA para. 3418. Thus in the *Bateson* case the Board found certain claims of the contractor meritorious and *recommended* an upward equitable adjustment in a stated amount. It went on to say, however, that payment was barred by law to the extent that this amount together with sums already paid under the contract exceeded the statutory limit. The Board's disposition of Capehart cases in which this fund problem arises depends on which of the military departments is sponsoring the construction. In each of the three departments an Assistant Secretary submitted his own instructions to the Board as to disposition of such cases. See the brief discussion of these instructions in the *Fort Sill* case, *supra*.

<sup>123</sup> Remler Co. Ltd., ASBCA No. 5296 (Sept. 4, 1959), 69-2 BCA para. 2336; S. Volpe & Co., Inc., ASBCA No. 7710 (April 6, 1962), 1962 BCA para. 3350; JAGT 1961/7310 (Oct. 3, 1961).

<sup>124</sup> Tidewater-Kiewit-P.E.C., ASBCA No. 6971 (Oct. 6, 1961), 61-2 BCA para. 3178; The Harris Coal Co., ASBCA No. 1263 (March 14, 1958), 58-1 BCA para. 1688; General Installation Co., ASBCA No. 2061 (Dec. 14, 1954), digested in DA Pam 715-50-1, Changes para. 7 (1957).

<sup>125</sup> This is the so-called *Sewerin* doctrine, named after a Court of Claims decision, *Severin v. United States*, 99 Ct. Cl. 435 (1943), *cert. den.*, 322 U.S. 733 (1944). This doctrine was cited with approval in the *General Installation* case, note 124 *supra*, and in *Farnsworth & Chambers Co.*, ASBCA Nos. 5768-72, 6966, and 5967 (July 26, 1960), 60-2 BCA para. 2717, digested in DA Pam 715-50-67, § II, para. 3 (1960). See also *J. W. Bateson Co.*, ASBCA No. 6100 (Oct. 23, 1961), 61-2 BCA para. 3184. In other cases the ASBCA has been reluctant to apply the doctrine. For example, in *Morrison-Knudsen, Inc.*, ASBCA No. 4929 (Aug. 16, 1960), 60-2 BCA para. 1992, the Army panel stated that the *Sewerin* doctrine did not apply where a prime contractor appealed on behalf of a subcontractor to obtain a prime contract price adjustment under the Changed Conditions Clause. The decision stated that relief under that clause is conditioned upon proof that a changed condition has caused either the prime contractor or his subcontractor to incur additional costs; the fact that the prime contractor may have protected itself from liability to the subcontractor for the additional costs is immaterial. In *A. DuBois & Sons*, ASBCA No. 5176 (Aug. 31, 1960), 60-2 BCA para. 2760, digested in DA Pam 715-60-70, § II, para. 12 (1961), the Board held that the *Sewerin* doctrine does not apply to Government delays under the Government-Furnished Property Clause. For a comprehensive discussion of this problem see Hubbard, *The Sewerin Doctrine*, *Mil. L. Rev.*, October 1960, p. 191.

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*Other limitations on jurisdiction.* In addition to the foregoing limitations the Armed Services Board of Contract Appeals has held it is without jurisdiction to grant relief to a contractor whose contract was cancelled "by the contracting officer pursuant to direction of the Comptroller **General**,"<sup>126</sup> nor may it reform a **contract**,<sup>127</sup> nor grant relief on the basis of an implied **contract**,<sup>128</sup> nor correct mistakes in **bids**,<sup>129</sup> nor review the denial of a request for relief under Title II of the First War Powers Act<sup>130</sup> or its successor legislation, Public Law 85-804.<sup>131</sup>

*Rules of the Armed Services Board of Contract Appeals.* When a contractor appeals from the decision of a contracting officer, his notice of appeal is forwarded and docketed with the Armed Services Board of Contract Appeals which immediately sends a copy of its rules to the contractor.<sup>132</sup> These rules provide for the filing of a complaint within 30 days after receipt of notice of docketing by the Board, but the Board may extend this **time**<sup>133</sup> and has been liberal in doing **so**.<sup>134</sup> Where a complaint has not been filed, the Board in some cases has decided the appeal on the existing record<sup>135</sup> and in others has dismissed the appeal for lack of prosecution.<sup>136</sup> Apparently the action of the Board will depend on the completeness of the file before it. Each claim must be stated with **as** much particularity as is practical although no technical

<sup>126</sup> Model Engineering & Mfg., Inc., ASBCA No. 7079 (Aug. 24, 1961), 61-2 BCA para. 3131. Cf. Prestex, Inc., ASBCA No. 6572 (Jan. 30, 1961), 61-1 BCA para. 2937.

<sup>127</sup> Starck Van Lines, Inc., ASBCA No. 4647 (Dec. 16, 1958), 58-2 BCA para. 2036.

<sup>128</sup> William Sales Co., ASBCA No. 1840 (Oct. 22, 1954).

<sup>129</sup> Forgee Metal Products, Inc., ASBCA No. 2220 (Jan. 21, 1955); Vaughn Constr. Co., ASBCA No. 7881 (June 12, 1962).

<sup>130</sup> Title II, First War Powers Act, ch. 593, § 201, 55 Stat. 839 (1941). Consult Fenton Industries, ASBCA No. 2685 (June 30, 1955).

<sup>131</sup> 72 Stat. 972 (1958), 50 U.S.C. § 611 (1958). Consult Murray-Sanders & Associates, ASBCA Nos. 6725, 6941, 7030 (March 24, 1961), 61-1 BCA para. 2581.

<sup>132</sup> These rules are set out in Part 2 to Appendix A of ASPR. At the time this article was written the rules had not been amended to reflect the new charter of the Board.

<sup>133</sup> ASPR, Appendix A, Rule 5.

<sup>134</sup> See, for example, Penn Garment Company, ASBCA No. 4993 (Dec. 31, 1958), 58-2 BCA para. 2041.

<sup>135</sup> Wynn Enterprises, Inc., ASBCA No. 3028 (May 27, 1957), 57-1 BCA para. 1301; South Mississippi Manufacturing and Engineering Co., ASBCA No. 3350 (March 8, 1957), 57-1 BCA para. 1208.

<sup>136</sup> C. Norman Bryant, ASBCA No. 4969 (Dec. 31, 1958), 58-2 BCA para. 2047; Penn Garment Co., ASBCA No. 4993 (Dec. 31, 1958), 58-2 BCA para. 2041.

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**form is required.**<sup>137</sup> Documentary evidence in support of claims may be filed as exhibits to the complaint. After service of the complaint the Government has **60** days in which to answer; however, this time limit may also be extended by the **Board.**<sup>138</sup> In either case both the contractor and the Government may amend their pleadings at most any **time.**<sup>139</sup>

The rules provide for the usual prehearing procedures, such as **motions,**<sup>140</sup> **depositions,**<sup>141</sup> inspection of designated **documents,**<sup>142</sup> and prehearing conferences.<sup>143</sup> The contractor is entitled to a hearing<sup>144</sup> and has the right to present evidence.<sup>145</sup> Generally, the rules of evidence of the Federal District Courts in non-jury trials apply.<sup>146</sup> Following the hearing, the parties are given the opportunity to present briefs.<sup>147</sup> Then the Board's decision is made in writing and authenticated copies are forwarded simultaneously to both parties. Motions for reconsideration must be filed within 30 days of the receipt of a copy of the decision of the Board by the party filing the motion.<sup>148</sup> If it is not filed<sup>149</sup> within that time the motion will be **dismissed.**<sup>150</sup> If an appeal involves

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<sup>137</sup> ASPR, Appendix A, Rule 5. The Board does not follow strict rules of pleading. *Leader Manufacturing Company*, ASBCA No. 3532 (Aug. 30, 1957), 57-2 BCA para. 1418. For a case discussing the sufficiency of a complaint see *Design Service Co.*, ASBCA Nos. 3145 and 3146 (Jan. 31, 1958), 58-1 BCA para. 1608.

<sup>138</sup> ASPR, Appendix A, Rule 6. This rule also provides that when the Government files its answer it shall file with the Board the decision from which the appeal was taken, the contractor's letters, the contract together with its amendments and other documents material to the appeal which become part of the appeal file available for inspection at the offices of the Board in Washington, D.C.

<sup>139</sup> ASPR, Appendix A, Rule 8; *Clyde Collins, Inc.*, ASBCA No. 3976 (Jan. 6, 1958), 58-1 BCA para. 1580.

<sup>140</sup> ASPR, Appendix A, Rule 9.

<sup>141</sup> ASPR, Appendix A, Rule 12.

<sup>142</sup> ASPR, Appendix A, Rule 13.

<sup>143</sup> ASPR, Appendix A, Rule 14.

<sup>144</sup> Hearings may be waived. ASPR, Appendix A, Rule 18.

<sup>145</sup> ASPR, Appendix A, Rules 16 and 20. The contractor is given these rights contractually pursuant to the Disputes Clause.

<sup>146</sup> ASPR, Appendix A, Rule 20. In actual practice the Board is usually quite liberal in applying rules of evidence.

<sup>147</sup> ASPR, Appendix A, Rule 23. Briefs may also be submitted if the appeal is submitted without a hearing. ASPR, Appendix A, Rule 18.

<sup>148</sup> ASPR, Appendix A, Rule 29. On a motion for reconsideration the presentation of additional evidence has been allowed. *Tankersley Construction Company*, ASBCA No. 2363 (Nov. 9, 1956), 56-2 BCA para. 1127.

<sup>149</sup> Apparently, mere mailing will not suffice. The United States Army Japan Board of Contract Appeals, an intermediate overseas appeals board, has so held in applying its own rules requiring "filing" of a motion for reconsideration within 30 days. *Rafu Company, Ltd.*, USARJ BCA No. 156 (July 23, 1962).

<sup>150</sup> *Thermo Nuclear Wire Industries*, ASBCA No. 6026 (March 13, 1961), 61-1 BCA para. 3021.

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\$5,000 in amount or less, it may, at the request of the appellant, be processed under an Optional Accelerated Procedure.<sup>151</sup> These appeals are decided by one member of the Board who renders a short brief opinion.<sup>152</sup> Hearings are permitted if requested.<sup>153</sup>

**Performance must continue.** One might ask why the Government has established this elaborate disputes procedure. Why not let the contractor seek his remedy in a court? The answer is simple. The Disputes Clause grants the Government an invaluable right—the contractor's agreement to proceed with the performance of the contract in accordance with the contracting officer's decision pending final resolution of an **appeal**.<sup>154</sup> Thus the Government obtains what it primarily desires when it contracts—performance.

### V. JUDICIAL REVIEW

#### A. EXHAUSTION OF ADMINISTRATIVE REMEDIES

As stated earlier, under the Wunderlich Act a decision of the head of an agency or his authorized representative pursuant to a contractual disputes clause is final and conclusive unless it is (1) fraudulent, capricious, or arbitrary, (2) so grossly erroneous as necessarily to imply bad faith, (3) not supported by substantial evidence, or (4) pertains to a question of law. Conversely, if a contractor can show any of these conditions exists, he may secure a review in a court of appropriate jurisdiction.<sup>155</sup>

Before seeking such review, however, a contractor must pursue the remedy provided by the Disputes Clause unless the appeal procedure is inadequate or unavailable.<sup>156</sup> Except where a statute

<sup>151</sup> ASPR, Appendix A, Rule 31. This rule provides that the resort to the Optional Accelerated Procedure is subject to the concurrence of the Department concerned. The new Charter provides that on the request of the appellant, an appeal involving \$5,000 or less "shall be decided under accelerated procedures as provided by the Rules of the Board." This may be interpreted as granting an absolute right to this procedure not subject to Departmental concurrence.

<sup>152</sup> ASPR, Appendix A, Rule 28 (b).

<sup>153</sup> ASPR, Appendix A, Rule 31.

<sup>154</sup> Pennsylvania Testing Laboratory, Inc., ASBCA No. 6185 (Nov. 28, 1961) (existence of a dispute over interpretation of a contract does not excuse a refusal to perform).

<sup>155</sup> For claims not exceeding \$10,000, the Court of Claims and United States district courts have concurrent jurisdiction. For claims exceeding \$10,000, the Court of Claims has exclusive jurisdiction. 28 U.S.C. §§ 1346, 1491 (1958).

<sup>156</sup> United States v. Holpuch Co., 328 U.S. 234 (1946); United States v. Blair, 321 U.S. 730 (1944). In Henry E. Wile Co. v. United States, 144 Ct. Cl. 394 (1959), the Court of Claims refused to take jurisdiction because the plaintiff-contractor, after receiving an adverse decision from an intermediate appeals board, failed to appeal to the ASBCA, as the contract required.

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provides otherwise, the extent to which a plaintiff is required to pursue his administrative remedy is a matter within the discretion of the court.<sup>157</sup> An example of a case in which a court considered the appeal procedure to be inadequate was where, upon a timely appeal to the Armed Services Board of Contract Appeals by the contractor, the Government moved to dismiss the appeal because it concerned a question of law, and the Board took no action on the motion for two years.<sup>158</sup> In another case, after the contracting officer failed to make a decision for 18 months, the contractor filed suit in the Court of Claims. Eleven days later the contracting officer rendered a decision from which the contractor made a perfunctory appeal. The contractor continued to press his suit in the Court of Claims, which held exhaustion of administrative remedies was not necessary because the Government had delayed unreasonably.<sup>159</sup>

In *Idaho Falls Bonded Produce & Supply Co. v. United States*,<sup>160</sup> the contractor had appealed to the War Department Board of Contract Appeals from an adverse decision of the contracting officer, but withdrew his appeal when the Government moved to dismiss it on the ground that there was no dispute as to any question of fact. When the Government urged that the contractor's suit in the Court of Claims had to fail because the contractor had not exhausted his administrative remedies, the court, after agreeing that the Government's position before the Board was well taken, stated :

... we think that the Government may not rely upon a failure to pursue administrative remedies when it, itself, has taken the position that there was no remedy available and its adversary has acceded to that contention." "

If the decision of the contracting officer is on a matter over which the administrative board has no jurisdiction, or is on a question of law,<sup>162</sup> the contractor is not required to appeal to the board, but may pursue his remedy directly in a court of appropriate jurisdiction.<sup>163</sup> However, determining whether the board has jurisdiction, or whether a pure question of law is involved is a difficult one, so it is wise for a contractor to go to the board,

<sup>157</sup> Neely v. United States (Ct. Cl. No. 374-56, Jan. 18, 1961).

<sup>158</sup> Southeastern Oil of Florida, Inc. v. United States, 127 Ct. Cl. 480 (1953).

<sup>159</sup> Oliver-Finnie Co. v. United States, 279 F.2d 498 (Ct. Cl. 1960). *Accord*, Reinking v. United States, 233 F.2d 527 (Ct. Cl. 1960), digested in DA Pam 715-50-74, § 11, para. 9 (1961).

<sup>160</sup> 123 Ct. Cl. 842, 107 F.Supp. 952 (1952).

<sup>161</sup> *Id.* at 858, 107 F.Supp. at 957 (1952). *Accord*, United States v. Heaton, 195 F.Supp. 742 (D. Neb. 1961).

<sup>162</sup> Rust Engineering Co. v. United States, 86 Ct. Cl. 461 (1938).

<sup>163</sup> Maitland Bros., ASBCA No. 6607 (June 26, 1961), 61-1 BCA para. 3073.

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even if the trip is only a perfunctory one designed to protect the right to sue in a court.<sup>164</sup>

### B. QUESTION OF LAW

Although the Supreme Court has appeared to uphold the validity of a disputes clause providing for finality of administrative decisions on questions of law,<sup>165</sup> the Wunderlich Act now prohibits such a clause.<sup>166</sup> Thus if a contractor can convince a court that the dispute involves a question of law, he is assured of court review. As stated above, however, what is a question of law is not always easy to determine. For example, the Court of Claims has consistently held that any interpretation of a contract is a question of law.<sup>167</sup> Although by way of dictum the Supreme Court appeared to disagree in *Moorman v. United States*,<sup>168</sup> the Court of Claims adheres to its view.<sup>169</sup> In some cases the Court of Claims has gone

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<sup>164</sup> An example of a contractor submitting a pro-forma appeal for this purpose is *Burl Johnson & Associates*, ASBCA No. 7732, etc. (April 11, 1962).

<sup>165</sup> *United States v. Moorman*, 338 U.S. 457 (1950).

<sup>166</sup> The legislative history of the Act indicates that the prohibition against finality of administrative decisions on questions of law applies only with respect to contracts made after the Act. H.R. Rep. No. 1380, 83d Cong., 2d Sess. (1954), in 2 U.S. Code Cong. & Ad. News, 83d Cong., 2d Sess. 2191 (1954). Administrative decisions on questions of law made final by contracts let before the Act would appear to be subject to review only under the standards prescribed in the Act's first section, quoted in the text accompanying note 59. Even after the Act, however, there is no prohibition against providing for administrative decisions on questions of law so long as those decisions are not made final.

<sup>167</sup> *E.g.*, *Callahan Constr. Co. v. United States*, 91 Ct. Cl. 538 (1940). In this case the court stated "in contracts of this character where, . . . it is provided that the decision of the contracting officer and the head of the department shall be final and conclusive only as to questions of fact, a decision or ruling on a protest or appeal which involves or is based upon an interpretation and construction of a contract and the specifications is a decision on a question of law rather than the determination of a fact and does not preclude the consideration, decision, and determination by the court of the question in controversy, *including the facts.*" 91 Ct. Cl. at 616 (emphasis added).

<sup>168</sup> 338 U.S. 457 (1950).

<sup>169</sup> *Associated Traders, Inc. v. United States*, 144 Ct. Cl. 744 (1959); *Union Paving Co. v. United States*, 126 Ct. Cl. 478, 115 F.Supp. 179 (1953). In the *Associated Traders* case, the position of the Court of Claims worked to the disadvantage of the contractor. The contract had been terminated for default, and the contractor had been assessed the excess costs suffered by the Government when a recprocement was made. The ASBCA held that the assessment of excess costs was improper because the items obtained on repurchase were not, as the contract required, "similar" to the items as to which the default had occurred. The Comptroller General disagreed with the ASBCA, and the excess costs were withheld from the contractor. In his suit in the Court of Claims, the contractor contended that the ASBCA decision was final and binding on the Government. The court disagreed, stating that the meaning of the word "similar" was a question of law. Using the dictionary as a reference, the court agreed with the Comptroller General and dismissed the contractor's petition.

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even further. For example, in *Poloron Products v. United States*,<sup>170</sup> that court held that whether a timely appeal has been perfected within the meaning of the contract is a question of law.

Although some other federal courts have followed the Court of Claims' view that any interpretation of a contract is a question of law,<sup>171</sup> others appear to apply the rule that if testimony is needed in order to interpret the contract meaning, a question of fact is involved.<sup>172</sup>

### C. BREACH OF CONTRACT

As stated earlier, the Armed Services Board of Contract Appeals cannot allow compensation for any damages a contractor may suffer unless the contract authorizes an administrative adjustment. If the contract does not, the contractor's remedy is suit in a court for breach of contract. Occasionally, a contractor will seek relief before an administrative board and then, if not satisfied, will bring suit for breach of contract, contending the board's decision was a nullity because the board lacked jurisdiction.<sup>173</sup>

<sup>170</sup> 126 Ct. Cl. 816, 116 F.Supp. 588 (1953).

<sup>171</sup> *E.g.*, *Kayfield Constr. Co. v. United States*, 278 F.2d 217 (2d Cir. 1960); *United States v. Lundstrom*, 139 F.2d 792 (9th Cir. 1943) (whether materials actually hauled differed from those the contract required to be hauled).

<sup>172</sup> In *Brown & Co. v. M'Gran*, 39 U.S. (14 Pet.) 479 (1840), Justice Story stated: "It is certainly true, as a general rule, that the interpretation of written instruments properly belongs to the Court, and not to the jury. But there certainly are cases, in which, from the different senses of the words used, or their obscure and indeterminate reference to unexplained circumstances, the true interpretation of the language may be left to the consideration of the jury for the purpose of carrying into effect the real intention of the parties." 39 U.S. at 493.

In *Phoenix Tempe Stone Co. v. De Waard*, 20 F.2d 757 (9th Cir. 1927), the court stated: "Where a contract is written in words of common use and is free from ambiguity, it is for the court without testimony to declare its meaning, and for the jury to accept the construction put upon it by the court. But where technical terms of science, art or trade are employed, or common words are used in an unusual sense, or where—as here—symbols, lines, or marks are used, the significance of which is not commonly understood, testimony may be received from persons familiar with such use to explain the meaning and if the testimony is conflicting, it is for the jury in the light of the testimony to determine the real understanding and agreement of the contracting parties." 20 F.2d at 762.

Consult also *Lowell O. West Lumber Sales v. United States*, 270 F.2d 12 (9th Cir. 1959) where the court found that the contract did not clearly indicate whether it was a "call" or "requirements" contract and therefore the intent of the parties could be determined only by the conduct and conversations of the parties and the surrounding circumstances and, therefore, was clearly a factual determination. See also *J. T. Majors & Son, Inc. v. Lippert Bros., Inc.*, 263 F.2d 650 (10th Cir. 1958). In *United States v. Lennox Metal Manufacturing Co.*, 225 F.2d 302 (2d Cir. 1955), Judge Frank took the position in his concurring opinion that resort to extrinsic evidence is almost always necessary in interpreting the meaning of words appearing in a contract.

<sup>173</sup> See, for example, *Klein v. United States*, 285 F.2d 788 (Ct. Cl. 1961).

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This also occurs not infrequently where a contracting officer, purportedly acting under the Changes Clause, substantially increases or decreases work to be performed. If the change is too great it will be considered "beyond the scope of the contract," and the contractor will be entitled to damages. When a change must be considered to be beyond the scope of the contract and inconsistent with the Changes Clause is a matter of degree varying from one contract to another.<sup>174</sup>

### D. THE SUBSTANTIAL EVIDENCE TEST

The Wunderlich Act has given the courts an additional reason for exercising judicial review : where the administrative decision is not supported by substantial evidence. What is "substantial evidence" does not appear to have presented any **problem**,<sup>175</sup> but the extent to which the decision of an administrative board will be reviewed, has. The Court of Claims has taken the position that, in determining whether a board decision is supported by substantial evidence, it may hear the case *de novo* and not be restricted to review of the transcripts of the hearing before the board.<sup>176</sup>

When the question of the extent of judicial review permitted by the Wunderlich Act was first considered by the federal district courts and the courts of appeals, they took the position that the review would be limited to an examination of the record made before the administrative board and that a trial *de novo* would not be **permitted**.<sup>177</sup> But then the Court of Appeals, Ninth Circuit, stated that under a disputes clause :

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<sup>174</sup> *Saddler v. United States*, 287 F.2d 411 (Ct. Cl. 1961); *General Contracting & Constr. Co. v. United States*, 84 Ct. Cl. 570 (1937).

<sup>175</sup> The House Committee on the Judiciary, which considered the Wunderlich Act, stated: "As understood by the committee and as interpreted by the Supreme Court in *Consolidated Edison Company of New York v. National Labor Relations Board*, 305 U.S. 197 . . . 'substantial evidence' means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." H.R. Rep. No. 1380, 83d Cong., 2d Sess. (1954), in 2 U.S. Code cong. & Ad. News, 83d Cong., 2d Sess. 2191,2194 (1954).

<sup>176</sup> *Volentine & Littleton v. United States*, 136 Ct. Cl. 638, 145 F.Supp. 952 (1956). The Court of Claims seemed to deviate from this position in *P.L.S. Coat & Suit Corp. v. United States*, 180 F.Supp. 400 (Ct. Cl. 1960). However, the trial *de novo* approach of the Court of Claims seems well established. *Topkis Bros. Co. v. United States* (Ct. Cl. No. 391-57, Dec. 6, 1961); *H. L. Yoh Co. v. United States* (Ct. Cl. No. 435-55, April 7, 1961); *Carlo Bianchi & Co. v. United States*, 140 Ct. Cl. 500, 169 F.Supp. 514 (1959) (in this case the contractor presented only 4 witnesses before the administrative board, whereas in the court he presented 15); *Fehlhaber Corp. v. United States*, 138 Ct. Cl. 571, 151 F.Supp. 817 (1957), *cert. denied*, 355 U.S. 877 (1957).

<sup>177</sup> *Langoma Lumber Corp. v. United States*, 140 F.Supp. 460 (E.D. Pa. 1955), *aff'd*, 232 F.2d 886 (3d Cir. 1956); *Mann Chemical Laboratories, Inc. v. United States*, 174 F.Supp. 663 (D. Mass. 1958) (this opinion was a memorandum and order resulting from a pretrial conference to determine

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When the department or agency head has made a decision as to a question of fact it shall be final unless the same is 'fraudulent or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence.' From this it follows that the board's factual determination is binding on the Court unless it can find that the determination is subject to at least one of these defects. Here the district court failed to make such a finding. . . . Therefore, the matter must be returned to the district court for its determination of whether there is some basis within the meaning of Section 321 of Title 41<sup>178</sup> to prevent from being binding on the district court the finding of fact by the board. . . . This determination should be based on any further evidence the parties may wish to introduce on this issue.<sup>179</sup>

In other words, the Ninth Circuit appears to be saying that the judicial review should not be limited to a review of the record of the Board alone but rather should include any additional evidence the parties may wish to introduce as a collateral attack on the Board's decision. This view appears quite proper in cases where fraud is alleged for, as one court stated, "where it is alleged that the administrative appeals board acted fraudulently, the party charging the fraud should not be limited to the record before the board. He should be permitted to introduce evidence to prove such fraud."<sup>180</sup>

But what if the party alleges the decision is not based on substantial evidence? Should the party then be permitted to introduce additional evidence? In the decision just quoted from the court said no. "The sole question [here] is whether the Board's decision is supported by substantial evidence. This determination must be made by viewing the administrative appeal record, reading it as a whole and not by taking further testimony or having a trial *de novo*."<sup>181</sup> But then in a later case another Federal district court stated that although it was not clear to it what additional evidence could be presented upon this issue, "it appears certain that any such evidence must be limited to any proof that the findings of the Board were not based on the evidence presented,"<sup>182</sup> or, in other words, proof that the Board relied on outside or secret evidence for its decision.

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whether the plaintiff was entitled to a trial *de novo*. Although the court held the plaintiff was not entitled to a trial *de novo*, it appears testimony of the plaintiff was permitted in the actual trial of the case, 182 F.Supp. 40 (D. Mass. 1960); *Wells and Wells, Inc. v. United States*, 164 F.Supp. 26 (E.D. Mo. 1958), *aff'd*, 269 F.2d 412 (8th Cir. 1959).

<sup>178</sup> The Wunderlich Act.

<sup>179</sup> *Lowell O. West Lumber Sales v. United States*, 270 F.2d 12, 19 (9th Cir. 1959).

<sup>180</sup> *United States National Bank of Portland v. United States*, 178 F.Supp. 910, 912 (D. Ore. 1959).

<sup>181</sup> *Id.* at 912.

<sup>182</sup> *Union Painting Company v. United States*, 194 F.Supp. 803, 805 (D. Alaska 1961).

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In three other cases decided since the *Lowell O. West Lumber Sales case*,<sup>183</sup> the courts have refused to grant a trial *de novo* and have appeared to limit their review to matters within the record made before the administrative boards and it would appear that in review for substantial evidence, absent proof of secret evidence, this will continue to be the practice in the Federal District Courts and Courts of Appeals.<sup>184</sup> However, one case raised another question, but left it unanswered. May newly discovered evidence be used to attack the finding of an administrative board made pursuant to a disputes article? In this case<sup>185</sup> the defendant, who had been the contractor before the board, offered interrogatories to the district court containing newly discovered evidence tending to attack one of the findings of the board of contract appeals. The district court decided it had no authority to consider this evidence and even if it did it would not be enough to upset the finding of the board. The Court of Appeals sustained this action but stated: "If appellant's newly discovered evidence had been more significant, we would have been required to deal with the interesting and difficult question whether the district court should have considered this evidence."<sup>186</sup>

### E. REVIEW BY THE COMPTROLLER GENERAL

Although the Wunderlich Act appears to contemplate judicial review only, it was not the intent of Congress in passing it to exclude review of decisions of Boards of Contract Appeals by the Comptroller General<sup>187</sup> and on occasion he has done so. However, where a decision of a Board of Contract Appeals pertains to a question of fact, the Comptroller General has stated that his office has no right to disturb the decision unless it is fraudulent, capricious, arbitrary, so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence.<sup>188</sup> Nor will the Comptroller General consider a claim, within the scope of the Disputes Clause, where a contractor has failed to follow the pro-

<sup>183</sup> 270 F.2d 12 (9th Cir. 1959).

<sup>184</sup> *Berger Company v. United States*, 199 F.Supp. 22 (W.D. Pa. 1961); *Allied Paint and Color Works, Inc. v. United States*, 199 F.Supp. 285 (S.D.N.Y. 1960); *United States v. Hamden Co-Operative Creamery Company*, 185 F.Supp. 541 (E.D.N.Y. 1960), *affd*, 297 F.2d 130 (2d Cir. 1961).

<sup>185</sup> *United States v. Hamden Co-Operative Creamery Co.*, *supra* note 184. 186 297 F.2d at 134.

<sup>187</sup> See H.R. Rep. No. 1380, 83d Cong., 2d Sess. (1954).

<sup>188</sup> Ms. Comp. Gen. B-146102 (July 24, 1961).

cedure established by that **clause**.<sup>189</sup> However, if a decision is on a question of law, he will not consider it binding on his **office**.<sup>190</sup>

## VI. CONCLUSION

It appears to be popular belief that the route a government contractor must follow to obtain redress for his grievances against the federal government is such a confusing network of paths and passages that the federal government has actually given him no remedy at all. In other words, there is just too much red tape to overcome. This is not true. Although there are pitfalls along the route, the contractor is adequately warned of their existence. For, not only does the contract tell him what he must do to protect his interests, the administrative agencies lead him by the hand.

If the contractor does what he is told to do, he will find that he will be assured of the opportunity to have a fair and impartial hearing and receive adequate compensation for any wrong done to him.

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<sup>189</sup> 38 Comp. Gen. 749 (1949) ; 37 Comp. Gen. 568 (1958) ; Ms. Comp. Gen. B-142950 (Oct. 13, 1960).

<sup>190</sup> 34 Comp. Gen. 565 (1955). This involved a decision by a department that an escalator clause was applicable to increased costs incurred after the delivery schedule had been passed. The Comptroller General ruled the decision was on a question of law and **was**, therefore, not final and conclusive. Consult also 34 Comp. Gen. 20 (1954) and Ms. Comp. Gen. B-141586 (Jan. 13, 1960).

# REDUCING STATE AND LOCAL TAX COSTS TO COMPETE MORE EFFECTIVELY FOR GOVERNMENT CONTRACTS \*

BY LIEUTENANT COLONEL KARL E. WOLF \*\*

## I. INTRODUCTION

While there is considerable authority' for the philosophical proposition that literally nothing is certain except death and taxes, most government contractors face neither death nor certain taxation in the performance of their government contracts. An understanding of the law of taxation of government contractors and a knowledge of government procurement procedures can effect a material tax savings for a company selling to or performing contracts for the Government. In view of the highly competitive nature of most government procurement a three or four per cent tax savings which is reflected in the bid price may well result in the award of the contract. A company, which utilizes the combined tax and procurement information discussed herein, may be able to compete more effectively for government contracts and at the same time provide economy for the taxpayers from all the states. This article will discuss the following: first, the law with respect to what the states can legally tax on sales to the Government and its contractors ; second, a survey of what the states are currently taxing on such sales; and third, how the government contractor can reduce his tax costs by proper utilization of authorized procurement procedures in the state and local tax arena.

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\* This article is based in part upon an address delivered by the author at the Annual Conference, Tax Executives Institute, in White Sulphur Springs, West Virginia, on August 27, 1962, and which is being published in 15 Tax Executive 42 (1962). The opinions and conclusions presented herein are those of the author and do not necessarily represent the views of The Judge Advocate General's School, the Department of Defense, or any other governmental agency.

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<sup>1</sup> Boeing Airplane Co., 37 T.C. No. 64 (Jan. 10, 1962).

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### 11. WHAT THE STATES MAY TAX ON SALES TO THE GOVERNMENT?

The Supreme Court cases decided since 1940 indicate that not all government purchases and transactions come under the umbrella of intergovernmental tax immunity." The *Colorado Nat'l Bank v. Bedford*<sup>4</sup> decision, involving a service tax statute under which a tax was imposed on the users of safety deposit services of a federal bank, clearly established that the Court will consider the legal incidence of a tax in determining its constitutionality when federal immunity is claimed. That case held that a tax upon a transaction to which a government instrumentality is a party is permitted if the legal incidence of the tax is not upon the Government.' In concluding that the legal incidence of the tax was on the receiver or purchaser even though the other party was originally liable for the payment of the tax imposed, the Court in this and subsequent cases<sup>6</sup> relied upon some of the following statutory provisions: (1) The tax paid was required to be added to the service or sales price; (2) The amount of the tax was made a debt from the purchaser to the seller until paid and was recoverable at law in the same manner as other debts; (3) The seller was required to remit all taxes collected to the state treasurer less an amount covering the expense of collection; (4) The seller was

<sup>2</sup> For a discussion of recent developments in the law of taxation of government contractors, see Wolf, *Recent Developments in State Taxation of Government Contractors*, 14 Tax Executive 25 (1961).

<sup>3</sup> The doctrine of implied constitutional immunity, which was originally enunciated in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), has its basis in the supremacy clause of the Constitution. For over a century the Supreme Court proceeded to give a broad scope to this tax immunity doctrine. The peak was reached in *Panhandle Oil Co. v. Mississippi*, 277 U.S. 218 (1928), in which a Mississippi tax imposed on gasoline dealers for the privilege of selling, and measured at so many cents per gallon of gasoline sold, was held to be void as applied to sales to instrumentalities of the United States. With the changes in the economic climate in the thirties accompanied by the ever increasing needs of the states for revenue, the Supreme Court proceeded to curtail its extension of the scope of implied federal government immunity.

<sup>4</sup> 310 U.S. 41 (1940).

<sup>5</sup> The fact that a national bank, although a federal instrumentality for certain purposes, is not an agency of the United States Government in the sense that a government department is a branch of the Government of the United States does not appear to be a significant basis to distinguish the case. The Court stated that it assumed that the tax would be invalid if laid upon the bank as an instrumentality of Government and that its banking operations were free from state taxation except as Congress may have permitted. It should also be noted that the case of *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), which established the doctrine of implied constitutional immunity, also involved a federal bank.

<sup>6</sup> *Kern-Limerick, Inc. v. Scurlock*, 347 U.S. 110 (1954); *Federal Land Bank v. Bismarck Lumber Co.*, 314 U.S. 95 (1941); *Alabama v. King & Boozer*, 314 U.S. 1 (1941).

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forbidden to hold out directly or indirectly that he would assume or absorb the tax; and (5) The purchaser was allowed to recover illegally collected taxes and all sums paid by him as taxes were public money and trust funds of the state.

The *Alabama v. King & Boozer*<sup>7</sup> decision, involving a sales tax of the vendee type imposed upon a transaction between a lumber supplier and a cost-plus-fixed-fee contractor of the Government, rejected economic burden upon the Government as a basis for invalidating such a tax. The Court further found that the cost-plus-fixed-fee contractor involved was not an agent of the federal government. Therefore, the legal incidence of the vendee type tax was not upon the Government and no immunity from taxation resulted. Accordingly, the fact that materials are destined to be furnished to the Government by a cost type contractor does not prevent a vendee type sales tax being imposed on sales by a supplier to that contractor. Subsequent Supreme Court<sup>8</sup> and State court<sup>9</sup> cases indicate that a federal cost-plus-fixed-fee contractor may under appropriate circumstances be considered an agent of the federal government and thus immune from vendee type sales taxes because of the federal government's immunity. Other cases<sup>10</sup> clearly indicate that a state in its taxing statutes may not discriminate unlawfully against the federal government by imposing a vendor type sales tax on sales to the federal government and at the same time exempt sales to the state and political subdivisions.

This capsule summary indicates that to determine the validity of a sales tax upon direct sales to the federal government or its agent one must first determine whether the legal incidence is upon the seller or purchaser. This is accomplished by checking

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<sup>7</sup> 314 U.S. 1 (1941). In discussing the relationship of two independent taxing sovereignties in the same territory the Supreme Court stated: "The asserted right of the one to be free of taxation by the other does not spell immunity from paying the added costs, attributable to the taxation of those who furnish supplies to the Government and who have been granted no tax immunity. So far as a different view has prevailed, see *Panhandle Oil Co. v. Knox*, supra; *Graves v. Texas Co.*, supra, we think it no longer tenable." 314 U.S. at 9.

<sup>8</sup> *Livingston v. United States*, 364 U.S. 281 (1960); *Kern-Limerick, Inc. v. Scurlock*, supra note 6.

<sup>9</sup> *AVCO Mfg. Corp. v. Connelly*, 145 Conn. 161, 140 A.2d 479 (1958); *General Motors Corp. v. State Comm'n of Revenue & Taxation*, 182 Kan. 237, 320 P.2d 807 (1958); *Chrysler Corp. v. City of New Orleans*, 238 La. 123, 114 So.2d 579 (1959); *Tawes v. Aerial Products, Inc.*, 210 Md. 627, 124 A.2d 805 (1956).

<sup>10</sup> *United States v. Department of Revenue*, 202 F.Supp. 757 (N.D. Ill. 1962), *aff'd*, 31 U.S.L. Week 3126 (U.S. Oct. 15, 1962); *People ex rel Holland Coal Co. v. Isaacs*, 22 Ill.2d 477, 176 N.E.2d 889 (1961); *accord*, *Moses Lake Homes, Inc. v. Grant County*, 365 U.S. 744 (1961); *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. 376 (1960).

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for those elements of the statute which have, as previously indicated, been found to result in the tax being of the vendee type. If the purchaser is the Government or its authorized agent and the legal incidence is upon the purchaser (a vendee type tax), the tax is invalid. If the legal incidence is upon the seller (a vendor type tax), since the tax is not on the Government, it is valid unless the statute exempts sales to the Government as most states do, or the tax discriminates against the federal government. Moving one step away from the sales transaction between the supplier and the Government to the sales transaction between a supplier and a government contractor, who is not an authorized government agent, leads to the outskirts of federal immunity. Except for construction contractors, an exemption is provided in most states for such sales under a resale exemption or materials used in processing or manufacturing exemption. Federal government immunity does not enter into this situation except for the proposition that a tax upon sales by a supplier to a government contractor may be invalid if the tax statute is discriminatory by exempting only sales to contractors of the state and political subdivisions.

Federal immunity is also involved in the use tax area. By use tax is meant the type of tax which is designed to complement the sales tax by taxing a person for the use within the state of tangible personal property upon which a sales tax was not paid because the purchase was made out of the state. The implied immunity concept immunizes the federal government, including an authorized government agent, from taxation in its use of property it purchases." This immunity does not extend to contractors in their use of their own or government property. Hence, contractors, who are not considered to be agents of the Government, are subject to a use tax on personal property which they purchase out of state, become the owner of, and then use in the state in the performance of a government contract."? As early as 1941 the Supreme Court in *Curry v. United States*<sup>13</sup> sustained an Alabama complementary use tax imposed upon a contractor for materials purchased outside of and used within the state in the performance of his cost-plus-fixed-fee contract with the Government where the contract provided that title to such materials shall vest in the Government upon their delivery at the work site and in-

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<sup>11</sup> *United States v. Livingston*, 179 F.Supp. 9 (E.D.S.C. 1959), *aff'd*, 364 U.S. 281 (1960).

<sup>12</sup> *United Aircraft Corp. v. Connelly*, 145 Conn. 176, 140 A.2d 486 (1958); *Boeing Airplane Co. v. State Comm'n of Revenue & Taxation*, 153 Kan. 712, 113 P.2d 110 (1941).

<sup>13</sup> 314 U.S. 14 (1941).

apection and acceptance in writing by the contracting officer. The tax status of a contractor's use of property which he purchases out of state with title passing to the Government rests upon the terms of the statute involved unless he is an authorized government agent. If the statute imposes a tax upon use incident to ownership **and** the ownership of the property passes from the vendor to the Government with only use or possession in the purchasing contractor, no such tax may be **applied**.<sup>14</sup> On the other hand, if the statute authorizes a tax upon use or possession alone, regardless of ownership, then government ownership would not prevent application of such a tax to a government contractor for his use of this property, even though title passes directly to the Government from the **vendor**.<sup>15</sup> State court decisions must be looked to for the developments just described. Any attempt to discriminate against the federal government in this situation by exempting only contractors of the state and political subdivisions would necessarily result in such a tax upon government contractors being **invalid**.<sup>16</sup>

### 111. WHAT THE STATES ARE CURRENTLY TAXING ON SALES TO THE GOVERNMENT AND ITS CONTRACTORS

Having just developed what the states can legally tax on sales to the Government and its contractors, a brief survey of what the states are currently taxing on sales to the Government and its contractors is in order. As can be seen by the chart in the Appendix to this article, the rules just discussed have been applied to the tax laws of the fifty states and the District of Columbia to determine the tax status of each of the transactions described. Under each of the described sales or use situations, if the transaction is exempt from taxation by the laws of that state, an E is indicated and if it is taxed a T is indicated. A minus sign indicates there are exceptions to the status indicated.

A few key observations should be made. The states of Alaska, Delaware, Idaho, Massachusetts, Minnesota, Montana, Nebraska, New Hampshire, New Jersey, New York, Oregon, Vermont and Virginia do not have state sales or use taxes. Next, even with a state sales and use tax authorized, the states of Colorado, Mississippi, Ohio, and Connecticut afford the Government and its contractors the next most favorable tax treatment considering the exemptions authorized and the tax rates applied. Of all the states South Carolina and Illinois afford by far the most unfavorable

<sup>14</sup> See cases cited in note 9 *supra*.

<sup>15</sup> *City of Detroit v. Murray Corp.*, 355 U.S. 489 (1958).

<sup>16</sup> See cases cited in note 10 *supra*.

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tax treatment to government contractors and the Government. Only Illinois, Indiana and South Carolina impose their taxes upon the sale of both property and services to the Government while Hawaii, Kentucky and New Mexico impose taxes upon the sale of services to the Government but not upon the sale of property. In the use tax area only Alabama," Illinois, Louisiana,<sup>18</sup> North Dakota, South Carolina, Tennessee<sup>19</sup> and Washington attempt to impose a use tax upon a contractor for his use of government-owned property.

For the purposes of comparing the states in their sales and use tax treatment of government contractors a uniform scoring method was utilized to produce a state sales and use tax report card. In any case where the transaction was taxed the weighted average indicated at the top of each column was multiplied times the tax rate percentage for that state with an appropriate deduction for any limited exemptions indicated by a minus sign. The sum of these figures is indicated in the next to the last column on the chart and this was converted to a grade structure from A+ for the best tax treatment of government contractors to an F for the worst. The grade for each state is indicated in the last column on the chart.

### IV. WAYS OF REDUCING TAX COSTS

The treatment by the various states of the federal government and its contractors indicates ways the contractor can reduce his state and local tax costs by proper utilization of authorized procurement procedures. A review of state court decisions<sup>20</sup> involving purchases by cost type contractors indicates that state courts readily find that such contractors are agents of the federal government in making purchases of equipment and facilities pursuant to a government facilities contract.<sup>21</sup> Of course, as agents of the federal government they are entitled to the same immunity from taxation which is accorded the federal government. This agency concept and accompanying immunity has been accepted

<sup>17</sup> The validity of attempts by the Alabama authorities to impose such a tax upon government contractors is currently being litigated. *Associated Contractors v. Haden*, Equity No. 31736, Montgomery County Ct., Ala.

<sup>18</sup> The Supreme Court of Louisiana has held that such a tax may not be applied under the Louisiana Use Tax Statute which taxes use incident to ownership. *Chrysler Corp. v. City of New Orleans*, *supra* note 9.

<sup>19</sup> The validity of this tax is also in dispute. *United States Steel Corp. v. Boyd*, No. 80551, Davidson County Chancery Ct., Tenn.

<sup>20</sup> See cases cited in note 9 *supra*.

<sup>21</sup> A facilities contract is the method by which the Government has a contractor acquire, at government expense, needed production equipment and facilities for use in a related supply contract.

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In **Arizona**,<sup>22</sup> **Connecticut**,<sup>23</sup> **Kansas**,<sup>24</sup> **Louisiana**,<sup>25</sup> **Maryland**<sup>26</sup> and by a federal court in **South Carolina**.<sup>27</sup> In these decisions the courts have relied upon some of the following factors to find the contractor was an agent of the Government even though not specifically designated an agent in the contract: (1) contractor's purchases were approved in advance by the Government; (2) the contract provided that title to all items purchased passed directly to the Government upon delivery by the vendor; (3) contractor's purchase orders indicated that the material was purchased for the account of the U.S. Government; (4) upon delivery of the purchases they were marked or tagged as government property; and (5) the contractor received no profit on the purchases. Perhaps many contractors are needlessly paying sales and use taxes on their purchases under cost type contracts when they would be exempt from such taxes under the laws of that state because of their status as an agent of the federal government. This then suggests that contractors might be well advised to review their status by applying the factors mentioned with a view toward taking the benefits afforded by the agency theory if appropriate.

Another possible way of reducing tax costs is by a wise selection of the place and method of delivery of the supplies when bidding on a government contract. Pursuant to provisions of the **Armed Services Procurement Regulation**,<sup>28</sup> most invitations for bids or solicitations of proposals for the procurement of supplies involving shipments of **20,000** pounds or more permit submission of prices on the basis of delivery f.o.b. carrier's equipment, wharf, or freight station, at a specified point at or near the contractor's plant or on the basis of all transportation charges paid to destination. This then suggests that in cases of low weight, high dollar value items a contractor would be well advised to carefully consider the effect the choice of delivery points has upon state and local taxes. For example, a bidder in South Carolina submitting a bid in response to an invitation issued by an Army installation in Atlanta, Georgia, might find it considerably cheaper to bid on the basis of all transportation charges paid to destination. This

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<sup>22</sup> **State Tax Comm'n v. Graybar Electric Co.**, 86 Ariz. 253, 344 P.2d 1008 (1959).

<sup>23</sup> **AVCO Mfg. Corp. v. Connelly**, *supra* note 9.

<sup>24</sup> **General Motors Corp. v. State Comm'n of Revenue & Taxation**, *supra* note 9.

<sup>25</sup> **Chrysler Corp. v. City of New Orleans**, *supra* note 9.

<sup>26</sup> **Tawes v. Aerial Products, Inc.**, *supra* note 9.

<sup>27</sup> **United States v. Livingston**, *supra* note 11.

<sup>28</sup> **Armed Services Procurement Reg. para. 1-1302.1** (Aug. 21, 1961). (hereinafter cited as ASPR).

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would mean that title would pass to the Government at Atlanta, Georgia, and the sale would be immune from the vendor type sales tax of three per cent which the State of South Carolina imposes upon direct sales to the federal government in the state. A bid on the basis of f.o.b. carrier's equipment at contractor's plant in the state would be subject to such a tax. An important item to remember in this connection is that court cases<sup>29</sup> have consistently held that when shipments are made on government bills of lading, title passes to the Government upon delivery of the goods to the carrier.

Another aspect of defense procurement procedure which affects tax costs involves the benefits afforded by the title passing provisions of the progress payments and government property clauses of defense contracts. In accordance with procedures<sup>30</sup> established in the Armed Services Procurement Regulation, many invitations for bids and requests for proposals provide for inclusion of a progress payments clause in the contract upon request by the prospective contractor. The authorized progress payments clauses<sup>31</sup> provide that immediately upon the date of the contract, title to all parts, materials, inventories, work in process and special tooling, theretofore acquired or produced by the contractor and allocated or properly chargeable to the contract "shall forthwith vest in the Government; and title to all like property thereafter acquired or produced by the Contractor and allocated or properly chargeable to this contract as aforesaid shall forthwith vest in the Government upon said acquisition, production or allocation."<sup>32</sup> The government property clause<sup>33</sup> authorized for use in cost-reimbursement type contracts for supplies and services under which the contractor is to acquire for the account of the Government, material, special tooling, or certain industrial facilities provides that title to all property purchased by the contractor, for the cost of which the contractor is entitled to be reimbursed as a direct item of cost under the contract, "shall pass to and vest in the Government upon delivery of such property by the vendor." These two title vesting clauses, providing in effect for passage of title directly to the Government from the vendor without title ever vesting in the contractor, suggest a related tax savings benefit. If title never vests in the contractor on his purchases covered by the contract, neither a state sales

<sup>29</sup> *Illinois Central R.R. v. United States*, 265 US .209 (1924) ; *Indiana Dep't of State Revenue v. Bendix Aviation Corp.*, 237 Ind. 98, 143 N.E.2d 91 (1957).

<sup>30</sup> ASPR app. E-504.1.

<sup>31</sup> ASPR apps. E-510.1 & E-510.2.

<sup>32</sup> ASPR app. E-510.1.

<sup>33</sup> ASPR 13-503 (Nov. 15, 1961).

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tax<sup>34</sup> which is imposed upon a transfer of title of tangible personal property for a consideration nor a state use tax<sup>35</sup> which is imposed upon use incident to ownership could be applied to such purchases by the contractor. Contractors would be well advised to indicate a desire for progress payments where the Requests for Proposals or Invitations for Bids permit. With this tax exemption benefit available to most cost type contractors on their purchases from vendors it would certainly behoove such contractors to include *e* notice in their purchase orders indicating that "the material is purchased for the account of the U.S. Government."

Several state courts<sup>36</sup> have placed great reliance upon the use of such a procedure. In states which recognize exemptions for purchases by government contractors where title passes directly to the Government from the vendor, the failure of government cost plus contractors to indicate in their purchase orders either that title passes to the Government or that the materials are purchased for the account of the U.S. Government appears inexcusable. The contention by some tax authorities that the title vesting provisions in government contracts are just a gimmick to permit avoidance of state taxes indicates ignorance of the law and facts. Without use of the title vesting provision in the progress payments clause, it would not be lawful to make progress payments to contractors in order to relieve the material impact on the contractor's working capital caused by contracts requiring long lead time and large initial investments. This is clear from the terms of Title 31, United States Code, Section 529,<sup>37</sup> providing that "in all cases of contracts for the performance of any service, or the delivery of articles of any description, for the use of the United States, payment shall not exceed the value of the service rendered, or of the articles delivered previously to such payment." Fortunately the Comptroller General has decided that despite such provisions "payment may be made for articles in advance of their delivery into the actual possession of the United States if title therein has vested in the Government at the time of such payment, or if the articles are impressed with a valid lien in favor of the United States in an amount at least equal to the payment."<sup>38</sup> Of course by use of these title passing provisions the Government also protects itself from adverse effects which might otherwise result from private ownership of the property

<sup>34</sup> AVCO Mfg. Corp. v. Connelly, *supra* note 9.

<sup>35</sup> See cases cited in note 9 *supra*.

<sup>36</sup> *Ibid.*

<sup>37</sup> 60 Stat. 809 (1946), 31 U.S.C. § 529 (1958).

<sup>38</sup> 20 Comp. Gen. 917, 918 (1941).

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in the event a strike were to close the contractor's plant or bankruptcy were to require division of the contractor's assets.<sup>39</sup>

Cases indicate the advisability from the tax standpoint of research and development contractors insuring during negotiations that the executed contract accurately describes the true status of what the Government is procuring.<sup>40</sup> If a Contractor is required to deliver products of experimentation in the form of tangible personal property rather than just engineering services in the form of engineering reports (a "study" contract), a tax savings may be possible on items purchased by the contractor in performing the contract. Most states exempt from sales and use taxes, the sale of tangible personal property incorporated as a part of other property produced for sale by manufacturing, assembling or processing. If the contract requires the delivery of hardware, such as experimental missiles, the materials incorporated therein would fall squarely within the exemption mentioned. Of course, in such cases the Government, being the final purchaser or ultimate consumer, would also be exempt in all states except Illinois, Indiana and South Carolina. The most recent case on this subject was decided in December, 1961, by the Court of Appeals of Maryland in the *Comptroller v. Fairchild Engine & Airplane Corp.* decision.<sup>41</sup> Needless to say, this matter of whether the terms of the contract require hardware or engineering services from the contractor is also extremely important in states, such as New Mexico, which tax sales of services to the Government but exempt sales of tangible personal property to the Government.

Another unusual basis for exemption was recently claimed in a case, just decided, involving a gross receipts tax statute taxing total receipts derived from business and gross proceeds of sales.<sup>42</sup> An attempt was made by the state to apply the tax to amounts a cost-plus-fixed-fee contractor received from the Government to cover his fee as well as his reimbursable expenditures for materials used in the performance of the contract. The contractor contended that his only receipts subject to the tax were the amounts he received as a fixed fee. Relying upon the terms of his contract providing enumerated categories of costs shall be considered allowable items of cost when incurred or paid by the contractor in the performance of the contract, the contractor

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<sup>39</sup> *United States v. Ansonia Brass & Copper Co.*, 218 U.S. 452 (1910); *Shepard Eng'r Co. v. United States*, 287 F.2d 737 (8th Cir. 1961); *United States v. Davies*, 152 F.2d 313 (7th Cir. 1945).

<sup>40</sup> *United Aircraft Corp. v. Connelly*, *supra* note 12; *United Aircraft Corp. v. O'Connor*, 141 Conn. 530, 107 A.2d 398 (1954).

<sup>41</sup> 227 Md. 252, 176 A.2d 210 (1961).

<sup>42</sup> *Land-Air, Inc. v. Bureau of Revenue*, Civil No. 30900, Santa Fe County Ct., N. M.

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contended that when a cost accrued to the contractor he simultaneously accrued a receivable from the Government. Hence, it was contended that this meant the contractor lent his capital to the Government by paying necessary contract costs and received repayment of its loan when reimbursed for such costs. Stating that the continuing loan-payment process involved a capital transaction, not an income transaction, the amount of cost reimbursements were viewed as neither total receipts derived from business nor gross proceeds of sales within the terms of the statute. A California appellate court decision<sup>43</sup> holding in a contract action that a contractor's gross receipts under a cost-plus-fixed-fee contract were limited to the amount of the fixed fee was relied upon as authority. This approach might well be considered by cost type contractors facing such gross receipts taxes.

The Supreme Court in *Phillips Chemical Co. v. Dumas Independent School Dist.*<sup>44</sup> held that a state, in its taxing statutes, may not discriminate against the federal government. This opinion requires "that the State treat those who deal with the Government as well as it treats those with whom it deals itself." The *Olin Mathieson* cases<sup>45</sup> in Illinois clearly established that this concept applies to sales and use taxes. A review of the administration of state sales and use tax statutes indicates that discrimination against contractors of the federal government exists in six states in their tax treatment of sales of material to construction contractors. Michigan taxes sales of materials and supplies to construction contractors of the federal and state governments but by statute exempts sales to construction contractors of the political subdivisions as well as religious, charitable and educational institutions.<sup>46</sup> North Carolina accomplishes a similar unconstitutional discrimination by a statutory provision permitting refunds to counties, cities and towns for sales and use taxes indirectly incurred on building materials becoming a part of buildings erected for such political subdivisions.<sup>47</sup> A test case is currently underway in Michigan.<sup>48</sup> Maryland, by ruling of the Comptroller, has exempted contractors of the state, political subdivisions, as well as religious, charitable and educational institu-

<sup>43</sup> *Thomas v. Buttress & McClellan, Inc.*, 297 P.2d 768 (Cal. Dist. Ct. App. 1966).

<sup>44</sup> 361 U.S. 376 (1960).

<sup>45</sup> *United States v. Department of Revenue*, supra note 10; *United States v. Department of Revenue*, 191 F.Supp. 723 (N.D. Ill. 1961).

<sup>46</sup> Mich. Stat. Ann. § 7.555(4) (m) (1960).

<sup>47</sup> N.C. Gen. Stat. § 105-164.14(c) (Supp. 1961).

<sup>48</sup> *Merritt-Chapman & Scott Corp. v. Department of Revenue*, Docket No. 44322, Ingham County Cir. Ct., Mich. See *Knapp-Stiles, Inc. v. Mich. Dep't of Revenue*, Ch. Docket No. 64291, Kent Co. Cir. Ct., Mich., Aug. 15, 1962 (tax held invalid).

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tions from the sales and use tax on materials incorporated into the project without a similar exemption for federal contractors.<sup>49</sup> Rhode Island effects the same unconstitutional discrimination by regulation.<sup>50</sup> Iowa, by statute, has made provision for refunds to the state and political subdivisions for such taxes but not to the federal government.<sup>51</sup> Arkansas' discrimination is limited to a statutory exemption for sales of construction materials to contractors for use in construction or repair of state-owned and tax-supported hospitals and sanitariums.<sup>52</sup> With millions of dollars of federal construction being performed annually it is difficult to understand the absence of any action by construction contractors performing federal contracts in states such as Maryland<sup>53</sup> and Rhode Island to obtain the benefit of a sales tax refund on its purchases based upon this obvious discrimination.<sup>54</sup> This is especially unexplainable since such refunds could in most instances be retained by the contractor.<sup>55</sup>

<sup>49</sup> Retail Sales & Use Tax Rule No. 70, 3 CCH All-State Sales Tax Rep. Md. ¶42-573 (1961).

<sup>50</sup> Sales & Use Tax Reg., Contracts With Exempt Agencies, Institutions, and Organizations, 4 CCH All-State Sales Tax Rep. R.Z. ¶66-524 (1959).

<sup>51</sup> Iowa Code 4422.45 (1962).

<sup>52</sup> Ark. Stat. § 84-1904(p) (Repl. 1960).

<sup>53</sup> The Anne Arundel County (Md.) Circuit Court has already held that the discrimination involved prohibits collection of sales taxes from federal construction contractors. Pittsburgh-Des Moines Steel Co. v. Goldstein, Law Docket No. A-6903, Anne Arundel Co. Cir. Ct., Md., Aug. 1, 1962. An appeal has been taken by the State of Maryland. Baltimore Sun, Aug. 20, 1962, p. 30. Compare Martin Co. v. State Tax Comm'n, 225 Md. 404, 171 A.2d 479 (1961).

<sup>54</sup> It is noted that in both Maryland and Rhode Island the tax laws permit a claim for refund to be filed for three years after payment of the tax. Md. Code Ann. art. 81, § 348 (1957); R.I. Gen. Laws § 44-19-26 (1956).

<sup>55</sup> The current tax clause authorized for use in advertised contracts by ASPR 11-401.1, which was effective in November 1961, does not provide for a decrease in the contract price or for payment to the Government of any refund from illegally collected state and local taxes which were included in the contract price. Starting in the summer of 1961 a special clause providing for such refund was incorporated in advertised contracts providing for construction in Maryland. For the years prior to the use in 1961 of either the current ASPR 11-401.1 tax clause or the special clause just mentioned in the case of Maryland construction contracts, the contractor would also be entitled to retain any refund of state and local sales and use taxes which were imposed upon the contractor's purchase of materials which were incorporated into a federal construction contract. The earlier ASPR 11-401.1 clause, known as the "Federal, State, and Local Taxes" (Jan. 1958) clause, did provide for both increases and decreases in the contract price for increases or refunds of certain taxes which were included in the contract price. A close reading of subparagraph (c) (4) of that clause indicates that the provision for adjustments in the contract price does not apply to "any State and local taxes, except those levied on or measured by the contract or sales price of the services or completed supplies furnished under this contract, including . . . sales and use taxes." Under such a clause, unless the contract were a time and materials contract, a sales or use tax imposed upon a contractor's purchase of materials

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Of course it would well behoove contractors, who are forced to resort to litigation in the protection of their own and the Government's interest, to insure compliance with the terms of the tax statutes of the state involved as they pertain to what procedure must be followed, who is entitled to sue for refund, and in what court such suits must be filed.<sup>56</sup> A recent decision<sup>57</sup> by the Louisiana Supreme Court indicates that in Louisiana if a federal cost-plus-fixed-fee contractor pays under protest a tax assessed on his use of government property and is reimbursed by the Government, which is entitled under the contract to the money if recovered, such a contractor does not have the requisite pecuniary interest to maintain a suit for refund. Of course this does not necessarily mean that the State of Louisiana and the City of New Orleans will get a windfall of these illegally collected taxes. Supreme Court<sup>58</sup> and Comptroller General decisions<sup>59</sup> recognize that the United States is not bound by state statutes of limitations or subject to the defense of laches in enforcing its rights. The Comptroller General<sup>60</sup> has also indicated that the United States would be legally justified in deducting illegally collected taxes from federal payments due the state and city on other transactions.

In any suit or action for refund based upon unconstitutional grounds it is important to allege the proper grounds in a timely

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to be incorporated into a construction project would not be one which was "levied on or measured by the contract or sales price of the services or completed supplies furnished under this contract." Accordingly, the provision in that clause providing for a decrease in the contract price or refund to the Government of any taxes refunded to the contractor would not apply.

<sup>56</sup> *Kennecott Copper Corp. v. State Tax Comm'n*, 327 U.S. 573 (1946) (A Utah statute authorizing taxpayer who has paid taxes under protest to bring suit "in any court of competent jurisdiction" against the State to recover the tax, held not to grant consent to suits against the State in the federal courts); *Great Northern Life Ins. Co. v. Read*, 322 U.S. 47 (1944) (An Oklahoma statute authorizing payment under protest and providing suit for recovery of such taxes "shall be brought in the court having jurisdiction thereof" held to consent to suit in the state courts only and a suit for refund based upon discrimination under the Fourteenth Amendment could not be maintained in a federal court); *Spector Motor Serv., Inc. v. McLaughlin*, 323 U.S. 101, 105 (1944) (Court indicated it has "insisted that federal courts do not decide questions of constitutionality on the basis of preliminary guesses regarding local law" and that avoiding "such guesswork, by holding the litigation in the federal courts until definite determinations on local law are made by the state courts, merely heeds this time-honored canon of constitutional adjudication").

<sup>57</sup> *Chrysler Corp. v. City of New Orleans*, Civil No. 46,021, La. Sup. Ct. June 4, 1962.

<sup>58</sup> *United States v. Summerlin*, 310 U.S. 414 (1940); *Guaranty Trust Co. v. United States*, 304 U.S. 126 (1938).

<sup>59</sup> 36 Comp. Gen. 712 (1957).

<sup>60</sup> *Zbid*; 39 Comp. Gen. 816 (1960).

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manner.<sup>61</sup> In this connection waiting until the filing of briefs or the argument on appeal to assert for the first time the invalidity of a tax statute based upon implied federal immunity will not win law suits or permit appeals to the Supreme Court.<sup>62</sup> Cases<sup>63</sup> indicate the advisability of alleging with precision the basis for the claim of unconstitutionality of the taxing statute. The constitutional provision relied upon should be set forth specifically. In order to permit review by the appeal route to the Supreme Court instead of by grant of certiorari the validity of the state tax statute should be assailed and not just the tax assessment.<sup>64</sup>

Another area which deserves consideration by those firms involved in construction work for the federal government is the tax benefit accorded time and material contracts. By regulation or statute many states including Florida,<sup>65</sup> Rhode Island,<sup>66</sup> Texas,<sup>67</sup> Utah<sup>68</sup> and Wyoming<sup>69</sup> recognize that where the contractor contracts to furnish the material and supplies at a fixed price and to render services in connection therewith either for an additional agreed price or on the basis of time consumed, the sale to the contractor of materials and supplies is for resale and not subject to tax. Of course then the sale of the materials by the contractor to the United States, as owner of the property and ultimate consumer, is subject to the exemption for sales to the Government. Accordingly, contractors would be well advised to consult with the government contracting officers prior to submitting proposals or bids for the purpose of reaching agreement on a method of segregating in the contract the charges for material and labor.

One aspect of tax costs on government contracts which may save costly mistakes is a thorough understanding of the tax clauses prescribed for use in advertised and negotiated contracts by Sections 11-401.1 and 11-401.2 of the Armed Services Procurement Regulation. Both clauses initially provide "Except as may be otherwise provided in this contract, the contract price includes

<sup>61</sup> *Wilson v. Cook*, 327 U.S. 474 (1946); *Charleston Fed. Sav. & Loan Ass'n v. Alderson*, 324 U.S. 182 (1945); *McGoldrick v. Compagnie Generale*, 309 U.S. 430 (1940).

<sup>62</sup> Wiener, *Wanna Make a Federal Case Out of It?*, 48 A.B.A.J. 59 (1962).

<sup>63</sup> *Id.* at 61.

<sup>64</sup> *Wilson v. Cook*, *supra* note 61; *Charleston Fed. Sav. & Loan Ass'n v. Alderson*, *supra* note 61.

<sup>65</sup> Sales & Use Tax Rule 51, 2 CCH All-State Sales Tax Rep. Fla. ¶30-551.

<sup>66</sup> Sales & Use Tax Reg., Taxability of Sales to or by Construction Contractors, 4 CCH All-State Sales Tax Rep. R.I. ¶66-520.

<sup>67</sup> Sales & Use Tax Rulings No. 9, 4 CCH All-State Sales Tax Rep. Tex. ¶70-509.

<sup>68</sup> Sales Tax Reg. 58, 4 CCH All-State Sales Tax Rep. Utah ¶71-558.

<sup>69</sup> Special Rule 33, 4 CCH All-State Sales Tax Rep. Wyo. ¶78-583.

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all Federal, State and local taxes and duties . . .,” and then there follows more specific provisions covering escalation and refund for certain taxes. The question of what was meant by the opening phrase “Except as may be otherwise provided in this contract” was decided by the Comptroller General in a decision<sup>71</sup> on November 6, 1961, in a case where a bidder added below his price quotation the words “This quotation does not include any Sales or Excise Tax levied or charged, either by the Federal, State or Municipal or any other Government Agency.” The opening phrase of the standard tax clause was found to contemplate only situations where the Government might wish to stipulate in the advertised invitation that certain taxes would not be applicable and should not be included in the bid price. Thus, if the invitation for bids includes the standard Federal, State and Local taxes clause and no provision is otherwise made in the invitation for the evaluation of tax-excluded bid prices and the award of a contract on that basis, any bid submitted on a tax-excluded basis without specifically identifying the classes and amounts of taxes which have been excluded would be considered nonresponsive to the invitation and rejected.

For contractors engaged in selling firearms and ammunition to the Government, an intriguing claim of exemption may be possible under Title 10, United States Code, Section 2385, which provides :

No tax on the sale or transfer of firearms, pistols, revolvers, shells or cartridges may be imposed on such articles when bought with funds appropriated for a military department.

The legislative history<sup>72</sup> of this statute shows rather conclusively that it was intended to provide tax exemption from a federal excise tax. In view of the statute’s broad proscription and the clear meaning of the words used, a court might take the position that it prohibited state taxation of such sales. Such action might be justified on the basis that legislative history should not be resorted to unless the meaning cannot be gained from the face of the statute.<sup>72</sup>

## V. CONCLUSION

Before state tax administrators think that tax avoidance on the part of government contractors in their dealings with the Government is being advocated without reason, it should be noted that in many states only by such avoidance will a federal government contractor get treatment equivalent to that which a contractor

<sup>70</sup> 41 Comp. Gen. 289 (1961).

<sup>71</sup> *Hearings on Second Supplemental Appropriation Bill, 1951 Before the Senate Committee on Appropriations*, 81st Cong., 2d Sess. 182, 183 (1950).

<sup>72</sup> 82 C.J.S. *Statutes* § 322 (1953).

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dealing with the state is accorded under the federal tax statutes. On sales to states, including gasoline sales, Federal Manufacturers and Retailers Excise taxes do not have to be paid even though those taxes are also of the vendor type.<sup>73</sup> Furthermore, supplies for further manufacture are also exempt from these federal taxes even where the final product is exempt because sold to a state.<sup>74</sup> There is no justification for one state to be tapping the pocket-books of the citizens of all fifty states by imposing a sales tax, even of the vendor type, upon sales to the federal government. There is no reason why the states of Illinois and South Carolina should be subsidized by the citizens of New York, New Jersey or Connecticut through the use of federal funds for the payment of sales taxes upon sales to the Government when they are not getting the same subsidy. A paraphrase of the Supreme Court decision in the *Phillips Chemical Co.* case<sup>75</sup> would indicate that "it does not seem too much to ask that the State treat those who deal with the Government as well as the federal government treats those with whom the State deals." The amount of direct and indirect federal financial assistance furnished to the states yearly tends to belie the often heard attempted justification that the federal government should pay its way.<sup>76</sup>

In conclusion, it might well be said that while the law on state taxation of sales to the Government is comparatively certain,<sup>77</sup> much depends upon what action the states have taken in passing their sales and use tax laws and much more depends upon what action the contractor takes to insure that the federal government gets the same fair tax treatment from the states which the federal government affords to the states.

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<sup>73</sup> Int. Rev. Code of 1954, § 4055; 26 U.S.C. § 4221 (a) (4) (1958).  
7426 U.S.C. § 4221 (a) (1) (1958).

<sup>75</sup> *Supra* note 44.

<sup>76</sup> H.R. Doc. No. 265, pt. 1, 87th Cong., 2d Sess. 340 (1962), indicates that in 1963 under a total budget expenditure of \$92.5 billion, federal financial assistance to State and local governments under existing or proposed programs will total an estimated \$9.9 billion, including net expenditures of \$6.3 billion from regular budget accounts and \$3.6 billion from the Highway and Unemployment trust funds. This amounts to over 10.7% of all federal expenditures and does not include many other huge federal expenditures which contribute to the state and local coffers in the form of state and local taxes paid directly or indirectly as a result of defense procurement.

<sup>77</sup> For a complete discussion of state taxation of government contractors, see Government Contracts Monograph No. 5: State and Local Taxation (Geo. Wash. U. 1962).



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## VI. APPENDIX 1.—Continued

### TAX STATUS OF TRANSACTIONS RELATED TO GOVERNMENT CONTRACTS

Aver. Wt.	SALES TAX							USE TAX							GRADE
	RATE %	SALE OF PROPERTY	SALE OF SERVICES	SALE 90 MFGS. OF MAT. INCORP. IN ITEMS SOLD GOVT.	SALE TO MFGS. OF MAT. CONSUMED IN PROD. OF ITEMS SOLD GOVT.	SALE TO 300L CONSTR. INCORP. IN PROJECT	SALE TO 300L CONSTR. CONTRACTOR OF MAT. CONSUMED	RATE %	USE OF CONTRACTOR	PROP. IN PERF. OF 300L CONTRACT	USE OF 300L PROP. IN PERF. OF 300L CONTRACT	USE OF CONSTR. MAT. BY 300L CONSTR. CONTRACTOR	SCORE		
GA.	3		E	E	T	T	T	3 1/2	T	T		T	48	D	
HAW.	3 1/2—1/2		T	T	T	T	T	3 1/2	T	T		T	55	D	
IDAHO														A+	
ILL.	3 1/2 + 1/2	T	T	E	T	T	T	3 1/2 +	T	(T)		T	131	F	
IND.	1 1/2—%	T	T	T	T	(T)*	T		T	T		(T)*	28	B	
IOWA	2		E	E	E	T	T	2	T	T		T	36	C	
KANS.	2 1/2		E	E	E	T	T	2 1/2	T	T		T	45	D	
KY.	3		E	E	E	T	T	3	T	T		T	75	E	
LA.	2		E	E	E	T	T	2	T	(T)		T	46	D	
MAINE	3		E	E	E	E	E	3	T	T		E	24	B	
MD.	3		E	E	E	(T)*	T	3	T	T		(T)*	48	D	

# STATE AND LOCAL TAX COSTS

MASS.	4	E	E	NO TAX	E	E**	E**	E**	4	Π—	E	(T)*	47	A+
MICH.														D
MINN.				NO TAX	E	T	T	T	3-1/2	T—	E	T	7	A+
MISS.	3-1/2	E	E	E	E	T	T	T	2	T—	E	T	28	A
MO.	2	E	E	E	E	T	T	T						B
MONT.				NO TAX	E									A+
NEB.				NO TAX	E	T—	T	T	2	Π	E	T	34	A+
NEV.	2	E	E	E	T—									C
N. HAMP.				NO TAX	E									A+
N. J.				NO TAX	E	T	T	T	2	Π—	E	T	52	A+
N. MEX.	2	E	E	T	T	T	T	T						D
N. Y.				NO TAX	E									A+
N. C.	3-1	E	E	E	T	(T)*	(T)*	(T)*	3-1	T—	E	(T)*	48	D
N. DAK.	2	E	E	E	T	T	T	T	2	T—	T—	T	38	C
OHIO	3	E	E	E	E	E	E	E	3	T—	E	E—	15	A
OKLA.	2	E	E	E	E	T—	T—	T—	2	T—	E	T—	20	B
ORE.				NO TAX	E									B
PA.	4	E	E	E	E	T	T	T	4	T	E	T	64	A+
R. I.	3	E	E	E	E	(T)*	(T)*	(T)*	3	T	E	(T)*	48	E
S. C.	3	T	T	E	T	T	T	T	3	T	T	T	114	D
S. DAK.	2	E	E	E	T	T—	T—	T—	2	T—	E	T—	30	F
TENN.	3	E	E	E	E	T—	T—	T—	3	T—	T—	T—	43	C
TEXAS	2	E	E	E	E	T—	T—	T—	2	T—	E	T—	2	D
UTAH	2 1/2	E	E	E	E	T—	T—	T—	2 1/2	T—	E	T—	34	B
VT.				E	T	T—	T—	T—						C
VA.				NO TAX	E									C
WASH.	4	E	E	NO TAX	E	E	E	E	4	T—	T—	E	40	A+
W. VA.	3	E	E	E	E	T	T	T	3	T—	E	T	42	D
WISC.	3—	E	E	E	E	T—	T—	T—	3—	T—	E	T	32	D
WYO.	2	E	E	E	E	T—	T—	T—	2	T—	E	T—	28	C
				E	T	T—	T—	T—						B

VI. APPENDIX 1.—Continued

TAX STATUS OF TRANSACTIONS RELATED TO GOVERNMENT CONTRACTS

TABLE OF SYMBOLS

- 
- E Exempt from taxation.
  - T Transaction is taxed.
  - \* Indicates tax is probably unconstitutional because of a discriminatory exemption.
  - ( ) Indicates State contends status is as indicated; however, tax is probably not applicable because of discrimination or other provision.
  - Indicates there are exceptions to the status indicated.
  - \*\* Indicates transaction is taxed under the use tax.

# OFFSHORE PROCUREMENT<sup>1</sup>:

BY LIEUTENANT COLONEL ROBERT S. PASLEY\*\*

## I. INTRODUCTION

### A. DEFINITION OF TERMS

The term "Offshore Procurement" is a misnomer but one that is too deeply entrenched to change. Moreover, it reflects in an interesting fashion the history of the sudden emergence of the United States Government, and more particularly the Department of Defense, as a large scale purchaser abroad.

In its original connotation, "offshore procurement" was a Navy coinage, referring to purchases made away from home for the immediate needs of the fleet, for example, fuel or subsistence supplies. When the military departments began large scale purchases abroad, around 1951, contracting officers familiar with Navy terminology began referring to such transactions colloquially as "offshore procurement." The phrase caught on and is now part of the language.<sup>3</sup>

Two kinds of "offshore procurement" should be distinguished: (1) purchases abroad for the use of the United States forces, financed out of Department of Defense appropriations (DOD-OSP); and (2) purchases abroad for the use of the forces of friendly foreign nations, financed out of military assistance appropriations (MAP-OSP). The former is a continuation of the traditional kind of offshore procurement; the latter is a new concept, which started with the Mutual Defense Assistance Program in 1949<sup>2</sup> (although it has some roots in the World-War II Lend-

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\* The author gratefully acknowledges the financial assistance of the Ford Foundation, which made possible the research on this article in Washington, D.C., Paris, and elsewhere in Europe, and expresses his appreciation to the many individuals in the Departments of Defense, Justice, and State, who so kindly furnished information and material. The opinions and conclusions presented herein are those of the author and do not necessarily represent the views of The Judge Advocate General's School or any other governmental agency, or of the Ford Foundation.

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<sup>1</sup> See U.S. Dep't of Army, Pamphlet No. 27-163, Procurement Law 265 (1961).

<sup>2</sup> Authorized by the Mutual Defense Assistance Act of 1949, ch. 626, 63 Stat. 714.

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Lease Program, and some immediate antecedents in the program of aid to Greece and Turkey under the Truman Doctrine of 1947).<sup>3</sup>

### B. VOLUME OF OFFSHORE PROCUREMENT

The relative percentages of DOD-OSP versus MAP-OSP have varied over the years, ranging from a ratio of about 10% DOD-OSP to 90% MAP-OSP, in 1955, to just about the reverse today. This shift reflects the history of the military assistance program, which gradually rose to a peak during the years from 1949 to 1953, and has since declined as the allied nations have assumed a greater share of responsibility for providing their own defense.

Despite the relative decline in the volume of MAP-OSP, the overall figure has remained high. The following table shows, in round figures, the amounts obligated for MAP-OSP during the fiscal years 1954 to 1961:\*

<i>Fiscal Year</i>	<i>Obligations for MAP-OSP</i> (in Millions of Dollars)
1954.....	\$ 448.9
1955.....	176.8
1956.....	72.1
1957.....	143.1
1958.....	41.4
1959.....	92.3
1960.....	78.1
1961.....	55.2
Total.....	\$1107.9

To any figures for MAP-OSP must be added the figure for DOD-OSP. For the years 1952 to 1957 DOD-OSP in Europe came to about \$1.5 billion and MAP-OSP to \$2.66 billion, a total of \$4.16 billion, or a little under a billion dollars a year.<sup>5</sup> Current estimates range from half a billion to a billion dollars annually, but the writer has been unable to verify these figures.

<sup>3</sup> Authorized by the Act of May 22, 1947, ch. 81, 61 Stat. 103. The purchase involved in *Gordon Woodroffe Corp. v. United States*, 122 Ct. Cl. 723, 104 F.Supp. 894 (1952), cert. denied, 344 U.S. 908 (1952), was an early, if unfortunate, example of a sort of offshore procurement contract, attempted to be placed under this act.

<sup>4</sup> Statistics furnished by Assistant General Counsel for International Affairs, Department of Defense.

<sup>5</sup> The figures on offshore procurement in Europe were obtained from Office of Sec'y of Defense, General Report, subject: *Negotiations for Recovery of Any Governmental Profits, or Excess Receipts, Under "No-Profits" Clauses of Offshore Procurement Bilaterals in the European Area* (June 30, 1958) (hereinafter referred to as the Hoagland Report).

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### C. OFFSHORE PROCUREMENT DISTINGUISHED FROM OTHER TYPES OF PROCUREMENT

Offshore procurement is to be distinguished, on the one hand, from non-contractual methods of obtaining supplies and services, and, on the other, from United States participation in or contributions to contractual procurement effected by international agencies and groups.

Examples of the former are wartime seizures of "booty" and requisitioning of supplies or services in occupied territory. These are governed by the laws of war, the Hague Regulations, and the Geneva Conventions.<sup>6</sup> In theory, they are unilateral acts of the military or occupying power, to which consent of the other party is irrelevant. It has happened, though, when a military occupation has continued long after the actual (as opposed to the legal) termination of hostilities, with peacetime conditions restored in all but name (as was the case in Western Germany immediately prior to the Bonn Conventions),<sup>7</sup> that "requisitioning" may assume more of a contractual appearance, even to the point of using standard contract forms, with only minor changes in language. Legally, however, it remains "requisitioning," a unilateral, non-contractual act, to which contract rules and regulations are inapplicable.\*

Examples of the second category to be distinguished from offshore procurement are the NATO infrastructure program, to the cost of which the United States contributes as a member of NATO, but which is carried out by NATO as an international entity, and the Weapons Production Program, a mutual procurement program in which the United States and other nations participate jointly (although the latter has offshore procurement aspects).

Contrasted with these, offshore procurement is contractual procurement effected by the United States as one contracting party with a foreign government or foreign supplier as the other. This article will treat mainly of offshore procurement in this sense,

<sup>6</sup> *Best v. United States*, 292 F.2d 274 (Ct. Cl. 1961), in U.S. Dep't of Army, Pamphlet No. 715-50-84, § 11, para. 9 (1962) (Procurement Legal Service); *Pauly v. United States* (Ct. Cl., No. 12-56, March 1, 1961). *Cf.* 71 Harv. L. Rev. 568 (1958).

<sup>7</sup> The Bonn Conventions first became effective in 1952. Convention on the Rights and Obligations of Foreign Forces and Their Members in the Federal Republic of Germany, with annexes, May 26, 1952, as amended by the Paris Protocol, Oct. 23, 1954 [1955] 6 U.S.T. & O.I.A. 4278, T.I.A.S. No. 3425, 332 U.N.T.S. 3, and as supplemented by the Convention on the Presence of Foreign Forces in the Federal Republic of Germany, Oct. 23, 1954 [1955] 6 U.S.T. & O.I.A. 5689, T.I.A.S. No. 3426.

<sup>8</sup> *Best v. United States*, *supra* note 6.

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although some attention will be paid to certain types of mutual procurement, because of their obvious kinship with offshore procurement proper and because they represent the most important current development in this area.

### D. PURPOSES OF OFFSHORE PROCUREMENT

The primary purpose of DOD-OSP is the same as that of DOD procurement in general: the obtaining of necessary supplies and services for the United States forces. Where these forces are stationed abroad, it is often more economical, both from the standpoint of time and money, to obtain supplies and services *in situ*. Where perishable supplies are involved, it may be a matter of simple necessity.

The primary purpose of MAP-OSP is the same as that of military assistance in general: to promote peace and security by providing support to friendly foreign nations and international organizations, with a view to the common defense against internal and external aggression.<sup>9</sup> Again, considerations of economy play an important role, since by definition the nations and organizations to be aided are located abroad.

An ancillary purpose of offshore procurement, especially MAP-OSP, but one which was more important in its earlier stages than it is now, is to provide a form of economic assistance to friendly foreign countries by awarding contracts to their nationals, and even more to the point, to help these nations establish a production base for building up their own sources of military supply.

While offshore procurement plays an important, if diminishing, role in military assistance, there are countervailing tendencies which tend to channel a substantial segment of foreign assistance, including military assistance, through domestic sources of supply and to that extent reduce the volume of offshore procurement. First, there is the strong protectionist bias which runs through government procurement, evidenced most clearly by the existence of the Buy-American Act,<sup>10</sup> but felt even more in the foreign assistance area. Secondly, there is the need, which has become acute in the last few years, to keep to a minimum the loss of our gold reserves and reduce the unfavorable balance of payments which has arisen to haunt our economy. These factors have resulted in some specific statutory and administrative restrictions

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<sup>9</sup> The purposes of the military assistance program, and of the foreign assistance program of which it is a part, are set forth in Sections 102 and 502 of the Foreign Assistance Act of 1961, 75 Stat. 424, 22 U.S.C. §§ 2151, 2301 (Supp. III, 1962).

<sup>10</sup> Act of March 3, 1933, ch. 212, tit. 111, 47 Stat. 1520, as amended, 41 U.S.C. §§ 10a-d (1958).

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on offshore procurement which will be discussed below. It was stated in 1960 that of every military assistance dollar, 88% is spent in the United States and only 12% overseas.<sup>11</sup>

### E. AUTHORITY AND FUNDS FOR OFFSHORE PROCUREMENT

The substantive authority for DOD-OSP is the same as that for DOD procurement, that is to say, the express or implied authority of the Department of Defense and of the military departments to contract for their needs.

Funds for DOD-OSP are provided under the applicable Department of Defense Appropriation Act. The latter does not, as a rule, provide funds for offshore procurement separate and distinct from funds for domestic procurement.

The substantive authority for MAP-OSP is found in the Foreign Assistance Act of 1961,<sup>12</sup> particularly Section 503 thereof, which authorizes the President to furnish military assistance, upon such terms and conditions as he may determine, to any friendly country or international organization, the assistance of which the President finds will strengthen the security of the United States and promote world peace and which is otherwise eligible to receive such assistance. One of the methods by which the President may do this is by "acquiring from any source and providing (by loan, lease, sale, exchange, grant, or any other means) any defense article or defense service."<sup>13</sup>

Funds for MAP-OSP are provided by the Foreign Assistance and Related Agencies Appropriation Act,<sup>14</sup> under the heading "Military Assistance." An interesting aspect of this is that the Foreign Assistance Act of 1961, *supra*, authorizes appropriations for military assistance on a two-year basis, the authorization for each of the fiscal years 1962 and 1963 being \$1,700,000,000. Of this authorization, \$1,600,000,000 was actually appropriated for fiscal 1962 and the President has requested \$1,500,000,00 for fiscal 1963.

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<sup>11</sup> Dep'ts of State and Defense, *The Mutual Security Program, Fiscal Year 1961—A Summary Presentation* 123-25 (March, 1960).

<sup>12</sup> 75 Stat. 424 (1961), 22 U.S.C. §§ 2151-2406 (Supp. 111, 1962). This act supersedes, with minor exceptions, the Mutual Security Act of 1954, 68 Stat. 832, as amended. Prior statutes were the Mutual Security Act of 1951 (65 Stat. 373, as amended) and the Mutual Defense Assistance Act of 1949 (63 Stat. 714, as amended), and numerous miscellaneous acts.

<sup>13</sup> Foreign Assistance Act of 1961, § 503(a), 75 Stat. 436, 22 U.S.C. § 2311(a) (Supp. III, 1962).

<sup>14</sup> *Eg.*, Foreign Assistance and Related Agencies Appropriation Act, 1962, 75 Stat. 717.

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The Foreign Assistance Act of 1961 provided that the funds authorized to be appropriated thereby "should remain available until expended." This phrase, if implemented, would have had the effect of creating a "no-year" appropriation, which remains available for obligation until it is exhausted, or until its purpose has been fulfilled, without regard to fiscal-year limitations.<sup>15</sup> In fact, however, the 1962 appropriation<sup>16</sup> was an ordinary one-year and not a no-year appropriation, that is, it remained available for obligation only during the fiscal year 1962.

The idea of a long-range authorization and a continuing appropriation is based on certain recommendations of the Draper Committee in its 1959 Report on the Organization and Administration of the Military Assistance Program," which were partially adopted by Congress. The Draper Committee had also recommended (1) that appropriations for military assistance be included as a separate title in the regular Defense Department Appropriation bill, the appropriations to be made directly to the Department of Defense, and (2) that requests for military assistance appropriations be included in the Department of Defense budget, but as a separate title where they would "compete" with the requests of the military departments for their own needs.<sup>18</sup> While these recommendations have not been adopted, as such, Section 504(b) of the Foreign Assistance Act of 1961 requires the President to establish procedures for programming and budgeting so that programs of military assistance come into direct competition for financial support with other activities and programs of the Department of Defense.<sup>19</sup>

### F. RESTRICTIONS ON OFFSHORE PROCUREMENT

As pointed out above, there are certain limitations on the use of offshore procurement even for the purpose of military assistance. The principal statutory restrictions are found in Section 604 of the Foreign Assistance Act of 1961,<sup>20</sup> which reads in part as follows:

*Section 604. Procurement.*

(a) Funds made available under this Act may be used for procurement outside the United States only if the President determines that such procurement will not result in adverse effects upon the economy of the

<sup>15</sup> U.S. Dep't of Army, Pamphlet No. 27-153, *supra* note 1, at 53.

<sup>16</sup> 75 Stat. 717 (1961).

<sup>17</sup> Second Interim Report of the President's Committee to Study the United States Military Assistance Program 22-23 (June, 1959).

<sup>18</sup> *Id.* at 20-22.

<sup>19</sup> See § 504(b) of the Foreign Assistance Act of 1961, 75 Stat. 436, 22 U.S.C. § 2312(b) (Supp. 111, 1962).

<sup>20</sup> 75 Stat. 439 (1961), 22 U.S.C. § 2354 (Supp. 111, 1962).

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United States or the industrial mobilization base, with special reference to any areas of labor surplus or to the net position of the United States in its balance of payments with the rest of the world, which outweigh the economic or other advantages to the United States of less costly procurement outside the United States, and only if the price of any commodity procured in bulk is lower than the market price prevailing in the United States at the time of procurement, adjusted for differences in the cost of transportation to destination, quality, and terms of payment.

The principal administrative restrictions are those imposed by President Eisenhower's directive of November 16, 1960,<sup>21</sup> and President Kennedy's memorandum of October 18, 1961.<sup>22</sup> The former directed the Secretary of Defense, *inter alia*, to "take promptly all possible steps to reduce by a very substantial amount the expenditures, from funds appropriated to the military services and for the military assistance program, that are planned for procurement abroad during calendar year 1961, by establishing a minimum amount by which such procurement shall be reduced." This portion of President Eisenhower's directive was affirmed by President Kennedy in his message to Congress of February 6, 1961.<sup>23</sup>

President Kennedy's memorandum of October 18, 1961, re-affirmed the policy that the preponderant bulk of foreign assistance procurement would be made in the United States, as a contribution toward resolving our balance of payment difficulties and as a help toward stimulating industries in labor surplus areas. On the other hand, "cogent trade and foreign policy objectives and assistance program goals require limited amounts of procurement outside the United States." Specifically, the memorandum directed that funds made available for military assistance programs not be used for procurement outside the United States except to procure items which are not produced in the United States, to make local purchases for administrative purposes, and to use available local currency. Upon certification by the Secretary of Defense, however, that exclusion of procurement outside the United States would seriously impede attainment of military assistance program objectives, the Secretary of Defense may authorize exceptions to these limitations.<sup>24</sup> The memorandum con-

<sup>21</sup> 25 Fed. Reg. 12221 (1960).

<sup>22</sup> 26 Fed. Reg. 10543 (1961).

<sup>23</sup> H.R. Doc. No. 84, 87th Cong., 1st Sess. (1961), in 44 Dep't State Bull. 287, 294 (1961).

<sup>24</sup> By Dep't of Defense Directive No. 2125.1 (Jan. 2, 1962), the Deputy Secretary of Defense exercised this authority by also authorizing MAP-OSP for (1) Government-to-Government cost-sharing projects under the Mutual Weapons Development Program, (2) certain Government-to-Government cost-sharing production projects, (3) procurement required to support overriding foreign policy objectives as approved by the Secretary of State, and (4) procurement required to support overriding military logistical considerations important to the defensive capability of the free world.

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cluded with a formal determination under Section 604(a) of the Foreign Assistance Act of 1961, *supra*, that the use of funds made available under the Act for procurement from sources outside the United States would not result in adverse effects upon the economy of the United States or the industrial mobilization base, with special reference to any areas of labor surplus or to the net position of the United States in its balance of payments with the rest of the world, which outweighed the economic and other advantages of less costly procurement outside the United States.

### 11. ADMINISTRATION OF MILITARY ASSISTANCE

The President has delegated his authority under the Foreign Assistance Act as follows: (1) to the Secretary of State all functions not otherwise delegated or reserved to the President; and (2) to the Secretary of Defense all functions relating to military assistance not otherwise delegated or reserved to the President, as well as certain related functions (with certain exclusions).<sup>25</sup> All funds made available for military assistance are allocated to the Secretary of Defense, with full power of reallocation and transfer.<sup>26</sup>

Under the Secretary of Defense, is an Assistant Secretary of Defense (International Security Affairs). On the staff of the latter is a Director of Military Assistance; this post is at present filled by an Army general officer with wide experience in the field. Legal advice is furnished by the Office of General Counsel, primarily by the Assistant General Counsel (International Affairs).

An important official abroad is the Defense Representative (DEFREPNAME) on the staff of the U.S. Mission to the North Atlantic Treaty Organization and European Regional Organization (USRO), Paris. His primary concerns in the procurement area, however, are with mutual procurement through NATO, the Weapons Production Plan, and so forth, rather than with offshore procurement in the strict sense.

In each foreign country military assistance, including offshore procurement, is ultimately the responsibility of the American Ambassador.'; On his staff is a Military Assistance Advisory Group (MAAG), with representatives from all three services and usually headed by a general or flag officer, which is charged with

<sup>25</sup> Exec. Order No. 10973, 26 Fed. Reg. 10469 (1961).

<sup>26</sup> Exec. Order No. 10973, *supra* note 25, Pt. V, §§ 501-02.

<sup>27</sup> Exec. Order No. 10893, Pt. 11, § 201, 25 Fed. Reg. 10731 (1960); President's Memorandum of May 27, 1961, "Responsibilities of Chiefs of American Diplomatic Missions," 26 Fed. Reg. 10749 (1961).

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primary responsibility for planning and coordination in this area. The actual procurement, whether DOD or MAP, is conducted by the service procuring activities, under the overall control of the area commander. In Europe, for example, Army offshore procurement is the immediate responsibility of local procurement activities and contracting officers, under the control of the Commander in Chief, USAREUR, at Heidelberg, with general policy supervision and coordination effected by Headquarters, European Command (EUCOM), a unified command located near Paris. In all cases close liaison must be maintained with the American Embassy and the local MAAG and, where appropriate, with DEFREPNAME and with the Washington offices concerned. Allowing for minor changes in detail, the organization in other overseas areas follows the same general pattern.

### 111. FRAMEWORK FOR OFFSHORE PROCUREMENT

#### A. *MUTUAL DEFENSE ASSISTANCE AGREEMENTS*

In accordance with the requirements of Section 402 of the Mutual Defense Assistance Act of 1949,<sup>28</sup> the United States has entered into a series of Mutual Defense Assistance Agreements with all countries receiving military assistance. A typical example is the U.S.-U.K. Agreement, concluded January 27, 1950.<sup>29</sup> Beside the matters required to be covered by the statute (use of assistance furnished, restrictions against further transfer, security, and the furnishing of equipment, materials, and services to the United States and other eligible nations), this agreement covers, in general terms, such matters as patent claims, use of sterling, tax relief, and diplomatic immunities.

Supplementing the basic Mutual Defense Assistance Agreements are a whole series of special agreements, such as tax relief agreements, agreements to facilitate interchange of patent rights and technical information for defense purposes, agreements on the disposition of military equipment, and special facilities assistance agreements. But the principal concern herein is with the agreements on offshore procurement, commonly known as "Memoranda of Understanding," and often simply as "bilaterals."<sup>30</sup>

<sup>28</sup> 63 Stat. 717 (1949).

<sup>29</sup> Mutual Defense Assistance Agreement With United Kingdom, Jan. 27, 1960, 1 U.S.T. & O.I.A. 126, T.I.A.S. No. 2017, 80 U.N.T.S. 261. See also Agreement With United Kingdom Relating to the Assurances Required Under The Mutual Security Act of 1961 [Exchange of Notes], Jan. 8, 1962, 3 U.S.T. & O.I.A. 4666, T.I.A.S. No. 2622, 126 U.N.T.S. 307.

<sup>30</sup> This term is confusing and should be avoided. It can refer to any of the types of agreements mentioned in the text.

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## B. MEMORANDA OF UNDERSTANDING

Although the impetus for special agreements on offshore procurement came from the military assistance program, and although they were undoubtedly inspired by the more general Mutual Defense Assistance Agreements, as drawn they apply to both MAP-OSP and DOD-OSP without distinction. Moreover, they cover both the situation where the contracts are placed on a Government-to-Government basis, the foreign government sub-contracting with its own suppliers for the end items, and the situation where the contracts are placed on a Government-to-Private-Contractor basis. The "Model Contract" attached to each Memorandum of Understanding, however, applies only to the former situation.

The first Memorandum of Understanding on Offshore Procurement was concluded with the United Kingdom in October, 1952.<sup>31</sup> Although this was the first to be concluded, and from some points of view one of the best, it is in certain respects atypical. One which is perhaps more typical of the general pattern is the U.S.-Netherlands agreement, concluded in 1954.

## C. U.S.-NETHERLANDS MEMORANDUM OF UNDERSTANDING

The Agreement Relating to A Memorandum of Understanding and A Model Contract between the United States and the Netherlands for the Offshore Procurement Program<sup>32</sup> was effected by an Exchange of Notes signed at The Hague on April 15 and May 7, 1954, and entered into force from July 30, 1954. Article 1 states the scope and purpose of the program, specifying that it covers material, services, supplies and equipment appropriate for United States military procurement and required either for the mutual security military aid program or for direct use of the United States forces. The program will be conducted by the United States in accordance with the laws of the United States governing military procurement and the mutual security program.

Article 2 provides for coordination of the U.S. procurement program with the Netherlands Government defense program.

Article 3 provides that contracts will be placed and administered on behalf of the United States Government by contracting officers of the United States Military Departments.

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<sup>31</sup> The text of this unpublished Memorandum of Understanding, and of the Model Contract annexed thereto, may be found in U.S. Dep't of Army, Pamphlet No. 27-150, Procurement Law—Statutes 303-20 (Appendix G) (1961).

<sup>32</sup> 5 U.S.T. & O.I.A. 2027, T.I.A.S. No. 3069, 213 U.N.T.S. 325.

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Article 4 provides that the United States may contract with the Netherlands Government or directly with individuals, firms, or other legal entities, and states the preference of the Netherlands Government for the latter method.

Articles 5, 6, and 7 cover, respectively, assistance in selecting subcontractors and in administering contracts, priorities for equipment and manpower, and security of classified materials and information.

Article 8 relates to inspection, and provides that it will be conducted, when requested, by representatives of the Netherlands Government, with United States Government representatives having the right of verification.

Articles 9 and 10 relate respectively to the providing of commercial bank priorities, and the granting of any necessary licenses.

Article 11 makes applicable to offshore procurement the provisions of the Netherlands-US. Agreement of March 7, 1952, on Tax Relief.<sup>33</sup>

Article 12 recites that standard clauses have been approved by the two Governments for use in contracts between them, as appropriate.

Article 13 affirms, somewhat obliquely, the principle of sovereign immunity, that the United States Government is immune from suit and its property exempt from legal process in the courts of the Netherlands in any matter arising out of offshore procurement. Article 13 also recognizes the diplomatic immunity of certain contracting officers and authorized procurement personnel.

Article 14 provides that the United States shall have freedom to designate the country which is to be the ultimate recipient of any end-item produced.

Article 15 states (a) that cost-plus-percentage-of-cost contracts and subcontracts will not be used; and (b) that, although the Netherlands has no renegotiation statute, the two governments may agree later on including appropriate provisions limiting the profits of subcontractors.

Article 16 provides for the furnishing of information on subcontracts placed under Government-to-Government contracts.

Article 17 states that on offshore procurement contracts entered into between the two Governments, it is intended that no profit of any nature will be made by the Netherlands Government, and

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<sup>33</sup> Agreement Relating to Relief from Taxation on United States Government Expenditures in the Netherlands for the Common Defense [Exchange of Notes, with Memorandum], March 7, 1952, 3 U.S.T. & O.I.A. 4183, T.I.A.S. No. 2563, 135 U.N.T.S. 199.

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provides for implementation of this understanding and the refund of any net profit which may ensue. This article does not affect any profit refunding provisions contained in individual contracts.

### D. US.-NETHERLANDS MODEL CONTRACT

Attached to the Memorandum of Understanding is a Model Fixed Price Contract for use in contracts between the United States Government and the Netherlands Government, setting forth the standard clauses referred to in Article 12. This is entitled "Negotiated Contract for the Procurement of Supplies, Services and Materials in the Netherlands." The first page states that the contract is entered into pursuant to Section 2(c) (1) of the Armed Services Procurement Act of 1947, as amended,<sup>34</sup> "and other applicable law."

The body of the contract consists of a schedule, in familiar form, twenty-two general provisions, and a signature page. The general provisions are substantially those set forth in the Armed Services Procurement Regulation,<sup>35</sup> with some minor changes in wording, plus the following more significant changes :

(a) Certain of the ASPR required clauses are omitted altogether, for example: *Additional Bond Security* (ASPR ¶7-103.9); *Disputes* (ASPR ¶7-103.12); *Renegotiation* (ASPR ¶7-103.13); and *Soviet-Controlled Areas* (ASPR ¶7-103.15).

(b) Other required ASPR clauses are omitted in their ASPR form, but the subject matter thereof is covered in different fashion. This is true of the clauses relating to taxes, default, labor regulations and standards, inspection, responsibility for supplies, termination, payments, filing of patent applications, copyright, technical information, reporting of royalties, and assignment of claims.

(c) General Provision 9, on *Subcontracting*, provides that the Netherlands Government in subcontracting will follow the same procurement methods and procedures which it follows in contracting for its own requirements. The Netherlands Government further agrees to indemnify the United States Government against any claims arising under the contract or any subcontract.

(d) A *Gratuities* clause is included (General Provision 13), although ASPR ¶7-104.16 says that it is required only when DOD funds are obligated. But in lieu of the long clause set forth in ASPR, which might conceivably offend international sensibilities, the clause is merely a cryptic reference to "the provisions em-

<sup>34</sup> 10 U.S.C. § 2301-2314 (1958), as amended.

<sup>35</sup> Hereinafter referred to as **ASPR** and cited as **ASPR**.

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bodied in Section 631 of Public Law 179 and Section 629 of Public Law 488, 82nd Congress of the United States and like provisions embodied in subsequent United States Appropriation Acts.”

(e) General Provision 16, *Guaranty*, provides that the Netherlands Government will pass on to the United States the benefit of any guarantee obtained in respect of any subcontract.

(f) General Provision 17, *Security*, is a detailed implementation of Article 7 of the Memorandum of Understanding. In general, each Government agrees to respect the other's security classification of any material or data and to give it substantially the same classification and protection under its own security system.

(g) General Provision 22, *Examination of Records*, follows ASPR 77-104.15, with minor changes in wording, and a maximum figure of \$1,000 instead of \$2,500 for excluded purchase orders. Of greater significance is the explanatory note that this General Provision may be omitted from contracts chargeable to appropriations for carrying out the Mutual Security Act of 1951, as amended (now the Foreign Assistance Act of 1961).<sup>36</sup> This authorization is in accord with ASPR 76-701, which *requires* omission of the clause in Mutual Security Act contracts with foreign governments, and *permits* its omission from contracts with foreign contractors other than governments, if such omission is approved by the contracting activity following a determination that such omission will further the purposes of the Mutual Security Act of 1954.<sup>37</sup>

(h) Finally, as befits the language of diplomacy, much of the peremptory wording of ASPR is softened and made more polite. An “order” becomes a “notice,” “instructions to the contractor” become “arrangements with the Netherlands Government,” “directed by the Contracting Officer” becomes “requested by the Contracting Officer,” “acceptable to the [U.S.] Government” becomes “mutually acceptable to the two Governments,” references to “fraud” on the part of the contractor are omitted, and so on. Hardbitten contracting officers are sometimes impatient of such niceties, but they are tremendously important nevertheless.

### E. GENERAL OBSERVATIONS

One of the great difficulties in negotiating these agreements in the early stages was the insistence on the part of some United States representatives to “go by the book,” and their fear that any deviation from strict ASPR language would be interpreted as a

<sup>36</sup> See note 12 *supra*.

<sup>37</sup> 68 Stat. 832 (1954), as amended.

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major concession and a sign of weakness. Some countries were so anxious to get the offshore procurement program started that they were willing to sign almost anything presented to them. Others quite understandably took the position that an international agreement was not in the same category as a contract with a Detroit manufacturer, and that a sovereign government should not, for example, be asked to submit to the "directions" of a mere contracting officer. For this, and other reasons (especially arguments over sovereign immunity, which *was* a matter of principle), an impasse developed which was finally broken only by firm and decisive action at the top. It is believed that the agreements finally negotiated preserved all essential interests of the United States, while making possible the accomplishment of a major mission which at the time was essential to the security of the free world.

### IV. LEGAL PROBLEMS OF OFFSHORE PROCUREMENT

There are probably as many or more legal problems connected with offshore procurement as there are provisions in the governing statutes and clauses in the Memoranda of Understanding and Model Contracts. Only a few can be taken up in this article.

#### A. CHOICE OF LAW

Some of the early offshore procurement contracts provided specifically that they were governed by the laws of the United States or, less felicitously, of the District of Columbia.<sup>38</sup> But this proved to be an unpalatable pill to ask some foreign governments and contractors to swallow. Many of the later contracts omit any reference to the problem, as does the model contract with the Netherlands discussed above. There is no such provision in the model contract with the United Kingdom,<sup>39</sup> France,<sup>40</sup> or Italy.<sup>41</sup> On the other hand, the model contract with Belgium states on the signature sheet: "The provisions of this contract shall be interpreted on the basis of the laws of the United States and the English language version of the contract."<sup>42</sup> Similar provisions

<sup>38</sup> Less felicitous, because, even within the United States, Government contracts are governed by federal law, not by the District of Columbia Code.

<sup>39</sup> See note 31 *supra*.

<sup>40</sup> Information obtained from Office of Legal Adviser, Hq., US EUCOM.

<sup>41</sup> Agreement Relating to Offshore Procurement Program With Italy With Memorandum of Understanding and Model Contract [Exchange of Notes], March 31, 1954, 5 U.S.T. & O.I.A. 2185, at 2229-43, T.I.A.S. No. 3083, 235 U.N.T.S. 293.

<sup>42</sup> Agreement With Belgium Relating to Offshore Procurement and Exchange of Notes, Sept. 2, 1953 [1954] 5 U.S.T. & O.I.A. 1311, T.I.A.S. No. 3000, 200 U.N.T.S. 127, as extended and amended, Nov. 19, 1953, 5 U.S.T. & O.I.A. 1334, at 1352, T.I.A.S. No. 3001, 233 U.N.T.S. 310; May 13 and July 19, 1954, 5 U.S.T. & O.I.A. 2254, T.I.A.S. No. 3085, 237 U.N.T.S. 342.

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appear in the model contracts with Luxembourg,<sup>43</sup> Spain,<sup>44</sup> and Yugoslavia.<sup>45</sup>

There are two questions here : (1) Is such a choice-of-law clause valid and enforceable? and (2) In its absence, what law governs the validity and interpretation of the contract?

On the first question, although certain older American cases raise some doubts,<sup>46</sup> it is generally conceded today that such a clause will be recognized in virtually all common-law and civil-law countries, within certain limitations.<sup>47</sup> A good statement of the modern rule is found in Section 332a of the Restatement of Conflict of Laws, Second (Tentative Draft No. 6).<sup>48</sup>

If the contract does not include a choice-of-law clause, there are three possibilities: (a) United States law would govern; (b) the law of the other country would govern; (c) international law would govern. Because of a paucity of litigation the question has arisen only rarely in connection with offshore procurement contracts, although it has been discussed in a few decisions of the Armed Services Board of Contract Appeals.<sup>49</sup>

(a) The most obvious argument in favor of applicability of United States law, the doctrine of the *Allegheny case*,<sup>50</sup> upon

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<sup>43</sup> Agreement With Luxembourg Relating to the Offshore Procurement Program, April 17, 1954 [1955] 6 U.S.T. & O.I.A. 3989, at 4027, T.I.A.S. No. 3415, 257 U.N.T.S. 255.

<sup>44</sup> Agreement Relating to Offshore Procurement in Spain, With Memorandum of Understanding and Standard Contract [Exchange of Notes], July 30, 1954, 5 U.S.T. & O.I.A. 2328, at 2348, T.I.A.S. No. 3094, 235 U.N.T.S. 45.

<sup>45</sup> Memorandum of Understanding with Yugoslavia Relating to Offshore Procurement With Standard Contract and Related Notes, Oct 18, 1954, 7 U.S.T. & O.I.A. 849, at 872, T.I.A.S. No. 3567, 273 U.N.T.S. 163.

<sup>46</sup> *Comm'r v. Hyde*, 82 F.2d 174 (2d Cir. 1936); *E. Gerli & Co. v. Cunard S. S. Co.*, 48 F.2d 115 (2d Cir. 1931). These cases appear to hold that while the question of *interpretation* may be made the subject of a choice-of-law clause, the question of *validity* depends on the law of the place where the contract is made.

<sup>47</sup> *Reese, Power of Parties to Choose Law Governing Their Contract*, 1960 Proceedings, Am. Soc'y Int'l L. 49, at 51, and authorities cited therein.

<sup>48</sup> Restatement (Second), Conflict of Laws (Tent. Draft No. 6, p. 14, 1960). See Reporter's Note to this section at pp. 25-30.

<sup>49</sup> Hereinafter referred to as the ASBCA. This Board is the representative of the various service Secretaries to decide disputes on appeal from decisions of contracting officers and intermediate boards.

<sup>50</sup> *United States v. County of Allegheny*, 322 U.S. 174 (1944). This case in turn is based on *Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943). In *Amtorg Trading Corp. v. Miehle Printing Press & Mfg. Co.*, 206 F.2d 103 (2d Cir. 1953), the court applied the *Clearfield* doctrine to a sale by an American corporation to a Russian state trading corporation, where the goods were to be shipped F.O.B. Milwaukee and to be used in Russia. No question of the possible applicability of Russian law was raised. Conversely, in *Banking & Trading Corp. v. Floete*, 257 F.2d 765 (2d Cir. 1958), *affirming* 147 F.Supp. 193 (S.D.N.Y. 1956), both the Court of Appeals and the District Court applied United States law to a sale of rubber by an Indonesian corporation to the

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closer examination proves wanting. The *Allegheny* case held that "the validity and construction of contracts through which the United States is exercising its constitutional functions, their consequences on the rights and obligations of the parties, the titles or liens which they create or permit, all present questions of federal law not controlled by the law of any state."<sup>51</sup> But that case involved a contract between the United States Government and a United States contractor, and the question presented to the Supreme Court was whether the federal law of the United States or the local law of one of the States should apply. The situation is rather different when the contract is one between the United States and a foreign government or foreign contractor, especially if the question should come before a foreign or international tribunal.

A possible argument can be found in the fact that the Memoranda of Understanding state typically that the offshore procurement program is carried out in furtherance of the principles set forth in Section 516(A) of the Mutual Security Act of 1951 (now Section 502 of the Foreign Assistance Act of 1961),<sup>52</sup> and the model contracts state that they are entered into pursuant to the provisions of Section 2(c) (1) of the Armed Services Procurement Act of 1947, as amended,<sup>53</sup> "and other applicable law." But these references to American statutes fall a little short of saying that the latter shall govern the validity and interpretation of the contract as a whole.

A stronger argument for applying United States law can be based on the fact that most of the clauses in the model contract, and presumably those in any Government-to-Private-Contractor contract, are all United States military procurement clauses, either required in so many words by United States statute or prescribed in the same or similar language by the Armed Services Procurement Regulation. Most of them have been construed many times by American courts and administrative bodies. It would be natural to assume that they are intended to carry with them the interpretations which have thus been placed upon them under American law. But this is a consideration which relates more to the problem of interpretation and has less bearing on the validity or enforceability of a contract or contract clause.

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**Reconstruction Finance Corporation, delivery to be F.O.B. steamer at a port in Java. The effect of certain decrees of the Netherlands East Indies Government was taken into account, but otherwise the possible applicability of Dutch or Indonesian law was not considered.**

<sup>51</sup> 322 U.S. at 183.

<sup>52</sup> 75 Stat. 434 (1961), 22 U.S.C. § 2301 (Supp. 111, 1962).

<sup>53</sup> 10 U.S.C. § 2304(a)(1) (1958).

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(b) The arguments for applying foreign law would be based on standard conflict-of-law rules applicable to contracts, that the law of the place of **making**,<sup>54</sup> or of **performance**,<sup>55</sup> or of **payment**,<sup>56</sup> controls or, under the latest theory, the law of the jurisdiction having the largest number of contacts with the transaction (the "center of gravity" theory).<sup>57</sup> While there is considerable competition and confusion as among these theories, in most cases the result would be the same: execution, performance, payment, and the "center of gravity" would nearly always be in the country in which the offshore procurement contract was placed.

There is little doubt that foreign law would govern subcontracts placed under Government-to-Government contracts. It is the accepted view in domestic procurement that local rather than federal law governs subcontracts placed under Government prime **contracts**,<sup>58</sup> although there are a few recent indications to the **contrary**.<sup>59</sup>

The situation is not so clear with respect to Government-to-Contractor contracts, and even less so with respect to Government-to-Government contracts. But there are a few decisions of **the** Armed Services Board of Contract Appeals (ASBCA) which have applied foreign law to Government-to-Private-Contractor contracts.

Thus, in *Fuji Motors Corporation*,<sup>60</sup> which involved an Army contract with a Japanese concern, the ASBCA held that Japanese law should apply, and that in interpreting specific provisions, such as one which invoked the cost principles of ASPR, Japanese business customs, usages, and accounting standards should be followed where they did not violate any law or public policy of the United States. However, where there was a dearth

<sup>54</sup> *Comm'r v. Hyde*, *supra* note 46.

<sup>55</sup> *Wm. J. Lemp. Brewing Co. v. Ems Brewing Co.*, 164 F.2d 290 (7th Cir. 1947).

<sup>56</sup> *Graham v. First Nat'l Bank of Norfolk*, 84 N.Y. 393, 38 Am. Rep. 528 (1881).

<sup>57</sup> *Vanston Comm. v. Green*, 329 U.S. 156 (1946); *Teas v. Kimball*, 257 F.2d 817 (5th Cir. 1958); *Auten v. Auten*, 308 N.Y. 155, 124 N.E.2d 99 (1954).

<sup>58</sup> *United States ex rel Lichter v. Henke Const. Co.*, 157 F.2d 13 (8th Cir. 1946); *Steele, Choice of Law, State or Federal, in Government Subcontracts*, 16 Fed. B.J. 202 (1956).

<sup>59</sup> *Am. Pipe & Steel Corp. v. Firestone Tire & Rubber Co.*, 292 F.2d 640 (9th Cir. 1961), 26 Albany L. Rev. 111 (1962), 61 Colum. L. Rev. 1519 (1961), 60 Mich. L. Rev. 219 (1961), U.S. Dep't of Army, Pamphlet No. 715-50-83, § III, para. 9 (1961) (Procurement Legal Service). *Cf.* Feldman, *The Subcontractor's Relationship to the Government*, 12 Fed. B.J. 299, at 308-09 (1952).

<sup>60</sup> ASBCA No. 2117 (June 12, 1958), 68-1 B.C.A. 71817, U.S. Dep't of Army, Pamphlet No. 715-50-2, Choice of Law ¶2 (1960) (Procurement Legal Service).

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of Japanese law on a particular subject, recourse could be had to United States law.

This decision followed two prior ASBCA cases, *Jac. A. Vonk's Handelmaatschappij N.V.*,<sup>61</sup> and *Philippine Sawmill Company*.<sup>62</sup> The former case involved an assessment for excess replacement costs after default where the contracting officer had failed to repurchase from the lowest bidder. The board considered the question of applicable law at some length and concluded that foreign law was probably applicable, but held that it made little difference since both the civil law and the common law placed substantially the same obligation on the party complaining of a breach to do everything reasonable to mitigate damages.

(c) On the third possibility, applying international law in lieu of either United States or foreign law, there is little or no authority for doing so in the case of Government-to-Private-Contractor contracts.<sup>63</sup> But it is reasonably clear that international law governs the Memoranda of Understanding, which are after all international agreements between sovereign states, and it is at least arguable that it should apply to individual Government-to-Government contracts.<sup>64</sup> The problem here would be the paucity of international law rules governing such matters as procurement of supplies and services. For some time attempts have been under way to formulate an international law of sales, and three draft statutes or agreements have been prepared: (1) the Draft Uniform Law on the Formation of Contracts for the International Sale of Goods, prepared by the International Institute for the Unification of Private Law in Rome; (2) the Preliminary Draft of a convention on a Uniform Law on the International Sale of Tangible Personal Property, prepared under the Inter-American Council of Jurists; and (3) the General Conditions for Sale prepared by the United Nations Economic Commission for Europe.<sup>65</sup> These are still only drafts, but at least they constitute a body of more or less generally accepted principles of international sales law which might be looked to in a given case.

As a practical matter, any tribunal purporting to apply international law would be forced to look primarily to the clauses found in the contract itself. As pointed out above, these are

<sup>61</sup> ASBCA No. 621 (undated), 5 C.C.F. ¶61083 (1950).

<sup>62</sup> ASBCA No. 569 (1951).

<sup>63</sup> See Sommers, Broches, and Delaume, *Conflict Avoidance in International Loans and Monetary Agreements*, 21 Law & Contemp. Prob. 463, 470 (1956).

<sup>64</sup> Id. at 476.

<sup>65</sup> Farnsworth, *Formation of International Sales Contracts: Three Attempts at Unification*, 110 U. Pa. L. Rev. 305, 306-09 (1962).

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clauses derived from United States law and regulations, which would presumably carry great weight if a problem of interpretation, or even of validity, should arise. In this connection, the practice of the International Bank for Reconstruction and Development (the World Bank) is of great interest. World Bank loan agreements provide that the rights and obligations of the parties shall be valid and enforceable according to the terms of such agreements notwithstanding any conflict with the law of any State or political subdivision thereof, and that none of the parties to a loan arrangement is entitled to claim that any provision of the agreement is invalid or unenforceable for any reason.<sup>66</sup>

An interesting question of international law is whether the Memoranda of Understanding are "international agreements" which must be registered with the United Nations Secretariat under Article 102 of the United Nations Charter.<sup>67</sup> If they are, the argument that they should be governed by international law is that much stronger. Whatever the legal answer, it is understood that the doubt has been resolved in favor of registration.

### B. SOVEREIGN IMMUNITY

When the military assistance program began, the United States took the position that it was part of a cooperative effort to defend the free world, of as much importance and benefit to the other countries concerned as to the United States. Accordingly, the United States was not willing to go forward with the offshore procurement program if it meant subjecting itself to litigation in foreign courts, whether at the suit of foreign governments, contractors, or third parties. It therefore sought to incorporate in each Memorandum of Understanding a statement that its sovereign immunity was recognized and would be protected in all cases arising out of the program.

Although this position was understandable, it seemed to run counter to a growing trend against sovereign immunity, a trend which the United States Government had itself recognized in the

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<sup>66</sup> Olmstead, *Economic Development Loan Agreements-Part I: Public Economic Development Loan Agreements; Choice of Law and Remedy*, 48 Calif. L. Rev. 424, 428 (1960).

<sup>67</sup> See Broches and Boskey, *Theory and Practice of Treaty Registration*, 4 Netherlands Int'l L. Rev. 159 (1957); Brandon, *Analysis of the Terms "Treaty" and "International Agreements" for Purposes of Registration under Article 102 of the U. N. Charter*, 47 Am. J. Int'l L. 49 (1953).

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famous Tate letter of 1952,<sup>68</sup> and which has received favorable notice by the United States Supreme Court.<sup>69</sup>

In general there are two views current today on sovereign immunity. The classical or absolute theory holds (with minor exceptions) that a sovereign may never be sued without his consent in the courts of another sovereign. The modern or restrictive theory holds that sovereign immunity is recognized with regard to sovereign or public acts of a state (*jure imperii*), but not with respect to private acts (*jure gestionis*).<sup>70</sup>

The classical theory is still recognized in most common-law countries (although a trend against it has set in in the United States), and in countries within the Soviet bloc. Germany apparently still adheres to it. The restrictive theory has always been supported in Belgium and Italy and more recently, although with some vacillation, in France, Austria, and Greece. A trend in favor of it is evident in the Netherlands." In other countries it is more difficult to say, but, in general, the older decisions support the classical theory, the newer tend to favor the restrictive theory.

The great difficulty with the restrictive theory is the problem of deciding when an action is *jure imperii* and when it is *jure gestionis*.<sup>72</sup> The Tate letter attempts to solve the problem, after

<sup>68</sup> Letter From the Acting Legal Adviser of the State Department to the U.S. Attorney General Concerning Sovereign Immunity of Foreign Governments. May 19, 1952, 26 Dep't State Bull. 984 (1962) (hereinafter referred to and cited as Tate Letter).

<sup>69</sup> Nat'l City Bank of New York v. Republic of China, 348 U.S. 356 (1955). A recent state court case adopting the restrictive theory is Et Ve Balik Kurumu v. B.N.S. Int'l Sales Corp., 25 Misc.2d 299, 204 N.Y.S.2d 971 (Sup. Ct. 1960), noted in 55 Am. J. Int'l L. 172 (1961), and discussed by Garretson, *International Law*, 1960 *Survey of American Law*, 36 N.Y.U.L. Rev. 13, 31-32 (1961). On the facts, however, the case does not seem to go further than the holding of the *Republic of China* case, that a foreign state which sues in an American court subjects itself to a counterclaim there.

<sup>70</sup> Tate Letter, *supra* note 68.

<sup>71</sup> *Ibid.*

<sup>72</sup> See, e.g., Brandon, *Sovereign Immunity of Government-Owned Corporations and Ships*, 39 Cornell L. & 425, 435-37 (1954). A Czechoslovakian scholar thinks the whole idea of the restrictive theory is a capitalist plot, attributable to hostility toward "the first Socialist State which brought the management of the entire national economy under the sovereignty of the State and introduced the monopoly of foreign trade." Zourek, *Some Comments on the Difficulties Encountered in the Judicial Settlement of Disputes Arising from Trade between Countries with Different Economic and Social Structures*, 86 Journal du Droit International [hereinafter cited as Clunet] 638, 649 (1959). *But see* rebuttal by Seidl-Hohenveldern, *Sovereignty and Economic Co-existence*, 86 Clunet 1050 (1959). Mr. George S. Leonard, formerly with the Department of Justice, has suggested that as a practical matter it makes very little difference which theory is espoused; even in the so-called restrictive countries the immunity actually granted is "considerably broader than would be anticipated from over-generalized assertions concerning *acta imperii* and *acta gestionis*." Leonard, *The United States As a Litigant in Foreign Courts*, 1958 Proceedings, Am. Soc'y Int'l L. 95.

pointing out that the United States has for some time not claimed immunity for its publicly owned *merchant* vessels, by simply stating that in the future the State Department will follow the restrictive theory in making recommendations to American courts on requests of foreign governments for a grant of sovereign immunity.

The proposed official draft of the Restatement of the Foreign Relations Law of the United States,<sup>73</sup> after first stating the general principle of sovereign immunity (§ 68), then provides that it “does not apply to proceedings arising out of commercial activities that the state carries on outside its own territory.” (§ 72). Comment a to Section 72 attempts to elaborate on this as follows:

In considering what is a commercial activity, the standard to be applied is the standard of the state exercising jurisdiction. There is at present, however, no agreement among states upon the criteria to be applied in determining what kinds of transactions are commercial. The courts of some states adopt as the criterion the nature of the transaction itself and, as a result, would consider the purchase by a foreign state of a cargo of boots, perfume or caviar as a commercial transaction not entitled to immunity. The courts of other states might inquire into the purpose of the transaction and hold, for instance, that the purchase of boots for the use of an army is not a commercial transaction and is therefore covered by the principle of immunity.

The Reporters' Notes to Section 72 state that the restrictive theory is “the prevailing view of international law,” and that it is more probable than not that it would be followed if a case presenting the problem were now to come before the Supreme Court of the United States. The literature on the subject is enormous and can only be barely indicated *here*.<sup>74</sup>

A more positive approach has been espoused by the International Bar Association in its “Oslo Resolution,” approved at Salzburg in 1960.<sup>75</sup> This proposes, *inter alia*, that :

3. A State may be made a respondent in a proceeding in a Court of another State :

<sup>73</sup> Restatement, Foreign Relations Law of the United States (Tent. Draft, May 3, 1962).

<sup>74</sup> A recent treatise is Sucharitkul, *State Immunities and Trading Activities in International Law* (1959). Among hundreds of articles, reference might be made to Lauterpacht, *The Problem of Jurisdictional Immunities of Foreign States*, 28 Brit. Yb. Int'l L. 220 (1951); Lalive, *L'Immunité de Jurisdiction de8 Etats et des Organisations Znternationales*, 84 Recueil des Cours 205 (Hague Academy of International Law, 1953-111); Setser, *The Immunities of the State and Government Economic Activities*, 24 Law & Contemp. Prob. 291 (1959); Fensterwald, *United States Policies Toward State Trading*, 24 Law & Contemp. Prob. 369, 386-96 (1959); Cardozo, *Sovereign Immunity: The Plaintiff Deserves a Day in Court*, 67 Harv. L. Rev. 608 (1954).

<sup>75</sup> *Limitation of Sovereign Immunity*, 6 A.B.A. Sec. Int'l & Comp. L. Bull. 28 (1960); *The International Bar Association Conference at Salzburg, Austria*, 7 Fed. Bar News 300 (1960).

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(h) When, in the territory of such other State, it engages in any industrial, commercial, financial or other business enterprise or activity in which private persons may there engage, and the proceeding is based upon the conduct of such enterprise or upon an act performed in the conduct of such enterprise or other commercial activity.

It can be seen that this places the emphasis on the nature, rather than the purpose, of the transaction.

Needless to say, the United States had no difficulty in establishing its position in those countries, such as the United Kingdom, which accept the classical theory. In those countries which espouse the restrictive theory, the United States took the position that offshore procurement is not a commercial transaction. The acquisition of military equipment and supplies is not only the exercise of a sovereign function, it is the highest type of sovereign function, the maintenance of the national defense. *A fortiori*, this is the case when not only the national defense, but also the defense of the whole free world, is at stake.

While military assistance is a new concept, precedent for this argument exists in the case of procurement for the national defense. Thus, in *Kingdom of Roumania v. Guaranty Trust Company*,<sup>76</sup> the United States Circuit Court of Appeals held that a foreign nation at war which makes contracts in the United States for supplies or equipment for its armies does not thereby divest itself of its sovereign character and become subject to suit as a private individual. The court said:

It seems to us manifest that the Kingdom of Roumania in contracting for shoes and other equipment for its armies was not engaged in business, but was exercising the highest sovereign function of protecting itself against its enemies."

A more recent federal case held that the operations of the Anglo-Iranian Oil Company to supply oil to insure maintenance and operation of a naval force was a sovereign activity of the British Government entitling the company to immunity from subpoena in the courts of the United States.<sup>78</sup>

If the emphasis is placed on the nature of the transaction rather than its purpose, it is possible to argue that the purchase of supplies, even by the military, is a commercial rather than a sovereign function. For example, on almost the same facts as in

<sup>76</sup> 250 Fed. 341 (2d Cir. 1918).

<sup>77</sup> *Id.*, at 346.

<sup>78</sup> Re Investigation of World Arrangements in Petroleum Production and Distribution, 13 F.R.D. 280 (D.D.C. 1952). The fact that a corporation, rather than the state itself, is involved does not necessarily defeat immunity if the corporation is "exercising functions comparable to those of a department or agency of the state." Restatement, Foreign Relations Law of the United States § 69(h) (Tent. Draft, 1962).

the *Guaranty Trust Company* case, the Italian courts ruled that this was a commercial transaction, not entitled to immunity.<sup>79</sup> Under the Oslo Resolution, which makes the test whether the transaction is one that a private party could enter into, it could be argued either way.<sup>80</sup> Certainly many military procurement contracts are for "off-the-shelf" items which anyone could buy. But perhaps more, and probably most important, offshore procurement contracts could not conceivably be entered into by a private party.

In any event, most of the countries which follow the restrictive theory accepted the argument of the United States and recognized the principle of sovereign immunity. The Memorandum of Understanding with France<sup>81</sup> is specific on the point. It says, in Article 14 :

The two Governments agree that offshore procurement contracts do not have a commercial character as regards the United States Government but are undertaken within the framework of the Mutual Defense Assistance Agreement of January 27, 1950, between the United States and France. Consequently, the United States Government in carrying out the offshore procurement program is entitled to the immunities from jurisdiction and legal process extended by French jurisprudence to foreign governments acting in their sovereign capacity.

But some countries refused to make even this concession. This was a stumbling block with Italy for a long time. Finally the impasse was resolved by accepting an indemnity agreement, under which the Italian Government agreed that it would save the United States Government harmless from any loss or damage which might be incurred as a result of any suit, lien, attachment, or other legal process or seizure in Italy against the United States Government or its property arising out of offshore procurement contracts, it being expressly understood that the United States was not waiving any immunity to which it might be entitled.<sup>82</sup>

<sup>79</sup> *Governo Rumeno v. Trutta*, 1 *Foro Italiano* 584 (1926), 1 *Giurisprudenza Italiana* 774 (1926). (Cited for this proposition by Lauterpacht, *op. cit. supra* note 74, at 223.) Sucharitkul, however, says that the Corte di Cassazione found that the contract contained an express waiver of immunity. Sucharitkul, *op. cit. supra* note 74, at 238, n.30. The French Cour de Cassation has granted immunity in this type of case. *Gouvernement Espagnol v. Casaux*, [1849] *Sirey Recueil General* I. 81; [1849] *Dalloz Jurisprudence* L 5. However, this was at a time when France espoused the absolute immunity theory. Sucharitkul, *op. cit. supra* note 74, at 207.

<sup>80</sup> Lauterpacht, *op. cit. supra* note 74, at 223-24. For this reason, Lalive thinks no such distinction can be drawn in the case of transactions by the military, and that they must all be considered *jure imperii*. Lalive, *op. cit. supra* note 74, at 285-86.

<sup>81</sup> Memorandum of Understanding on Offshore Procurement With France, June 12, 1953, art. 14.

<sup>82</sup> Agreement Relating to Offshore Procurement Program With Italy, *supra* note 41, art. 12.

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The problem of sovereign immunity has arisen in a number of foreign courts in recent years as a result of operations of our military forces abroad. But few, if any, of these cases have involved offshore procurement, probably because of the existence of the protective provisions in the governing agreements outlined above. Typical situations are suits against non-appropriated fund activities, or against named organizations or installations, usually arising out of employment disputes. In nearly every case, the sovereign immunity of the United States has been recognized, if not initially, then on **appeal**.<sup>83</sup> In many of the cases the courts specifically held that the operations of the United States Forces in Europe, under the North Atlantic Treaty, including the operation of post exchanges, were acts *jure imperii* and not *juri gestionis*. No case clearly holding to the contrary has been **found**.<sup>84</sup>

### C. CLAIMS, DISPUTES, AND LITIGATION

If sovereign immunity effectively precludes the foreign contractor from suing the United States in his own courts (except

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<sup>83</sup> *France*: Raynal v. Toul-Rosieres Officers' Open Mess, Court of Appeals, Nancy, Labor Section, May 18, 1961; United States v. Societe Immobiliere des Cites Fleuries Lafayette, Court of Appeals, Paris, Nov. 22, 1961; Enterprize Perignon v. United States, Court of Appeals, Paris, Feb. 7, 1962.

*Germany*: GEMA v. Kale, Court of Appeals, Frankfurt, Nov. 3, 1960; Wuliger v. Hq 7480th Supply Group (Spec. Act.), USAF, Labor Court, Wiesbaden, Docket No. 3 A 253/58 (1958).

*Greece*: Halkiopoulos v. United States, Athens Court of First Instance, Decree No. 7354/1959; United States v. Sarris, Athens Court of First Instance, sitting as Appellate Court, Decree No. 17544/1958.

*Iceland*: Brandsson v. Comdr. of U.S. Defense Forces, Supreme Court of Iceland, Oct. 4, 1961.

*Italy*: Dept. of the Army in U.S.A. v. Savellini, Corte di Cassazione (S. U.), Oct. 17, 1955, in 39 Rivista 91 (1956) (annotated at 92-102), discussed by Sucharitkul, *op. cit. supra* note 74, at 143-44; American Battle Monuments Comm. v. Diodati, Corte di Cassazione No. 1662/57 (1958); Novacco v. United States Navy, Court of Appeals, Naples, Nos. 2910/1957 and 1327/1957 (1959).

*Morocco*: United States v. Harper and London and Lancashire Insurance Co., Ltd., Court of Appeals, Rabat, June 6, 1961.

*Spain*: Marin Cano v. U.S.A.F. 3973d Air Base Group, Court of First Instance No. 5, Seville, March 3, 1959.

In general, see Doub, *Experience of the United States in Foreign Courts*, 48 A.B.A.J. 63 (1962).

<sup>84</sup> In *Katlein Constr. Firm v. United States*, Court of Appeals, Vienna, Austria, Dec. 15, 1960, plaintiff attempted to effect service by mailing a copy of the complaint (in German) to the Department of Justice in Washington. Defendant objected to the mode of service and also pleaded sovereign immunity. The Landsgericht held that the service, although valid under Austrian law, was void under international law, which required service through diplomatic channels, and so did not have to reach the question of sovereign immunity. The Court of Appeals reversed on procedural point on the ground that the service, although bad as to form, was valid in that it gave substantial notice. Apparently the question of sovereign immunity has not been finally decided.

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perhaps in a few countries like Italy), the question of what remedies he does have, in the event of an alleged breach or a dispute, becomes important. Of course subcontractors under Government-to-Government contracts have, as against their own Government, whatever remedies their local law provides. Absence of privity would normally bar any proceeding against the United States. But the problem is a real one in other situations. Three possibilities will be considered.

1. *Litigation.* The foreign government in a Government-to-Government contract would have the right to sue the United States in the United States courts for breach of contract, but ordinarily any controversy would be handled through diplomatic channels. A suit in the International Court of Justice is another remedy theoretically available, but it is highly unlikely that any such suit would be brought on an ordinary procurement contract.

In the case of a Government-to-Private-Contractor contract, the normal remedy for an alleged breach would be an action against the United States in the Court of Claims or in a Federal District Court under the Tucker Act.<sup>85</sup> In 1958, it was estimated that there were 30 or 40 such cases pending in the Court of Claims,<sup>86</sup> and it is unlikely that the number is substantially less today.

There are two difficulties here: One is the hardship imposed on a foreign contractor by requiring him to come to the United States to assert his claim. This is especially severe when the claim is a small one, or the contractor is a small business.<sup>87</sup>

The second difficulty arises from the concept of reciprocity. Section 2502 of title 28, United States Code, provides as follows:

**Citizens or subjects of any foreign government which accords to citizens of the United States the right to prosecute claims against their government in its courts may sue the United States in the Court of Claims if the subject matter is otherwise within such court's jurisdiction.**

This means that a plaintiff from State X must prove that an American citizen suing the Government of State X in the courts of State X is treated no less favorably than the nationals of State X. Does it go further and mean that the plaintiff must also prove that an American citizen could maintain against the Government of State X the *precise suit* which the plaintiff is bringing against the United States? This was the question before the Court of Claims in *Nippon Hodo Company Ltd. v. United States*,<sup>88</sup> which involved actions by Japanese corporations against the United

<sup>85</sup> 28 U.S.C. §§ 1346(a)(2), 1491 (1958).

<sup>86</sup> Leonard, *op.cit. supra* note 72, at 101.

<sup>87</sup> *Id.* at 102.

<sup>88</sup> 285 F.2d 766 (Ct. Cl. 1961), 1962 Duke L. J. 145, U.S. Dep't of Army, Pamphlet No. 715-50-75, § III, para. 9 (1961) (Procurement Legal Service).

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States on contract claims. Plaintiff produced a deposition from a Japanese attorney stating unequivocally that an American shared equally with a Japanese citizen "the right to sue the Japanese State for breach of contract," but failed to submit any Japanese cases in which the State had actually been sued for breach of contract. The court, one judge dissenting, held that plaintiff had met the burden of the statute. The court observed that the the Japanese rarely resort to litigation. "The result is a paradox: state liability in Japan is a commonly accepted fact but its proof by statutes and cases is difficult."<sup>89</sup> In rejecting the defendant's argument, the court said:

Such a position, if accepted, would add no luster to the golden rule of conduct that long has guided our country in its international affairs. Furthermore, we doubt that it is in harmony with the attitude of Americans everywhere that their country is strong, generous, and willing to lead and act first.<sup>90</sup>

Under this interpretation of the Court of Claims, the problem of proving reciprocity is probably not a major one:<sup>91</sup> most states today permit themselves to be sued on contract in their own courts, by both nationals and foreigners.

2. *Disputes Procedure.* Of greater practical value to the average foreign contractor than the possibility of suit in the Court of Claims is the settlement of his claim under the disputes clause of his contract. We have seen that such a clause does not normally appear in the Government-to-Government model contract. But it is customarily included in Government-to-Private-Contractor contracts.

One difficulty here, especially at first, was in getting foreign contractors to accept the very idea of the disputes clause, with its provision for unilateral determination by the contracting officer. Such a provision, they argued, was onesided and unfair, contrary to their notions of jurisprudence, and even illegal. Thus, in *Nissan Motor Company, Limited*,<sup>92</sup> the Japanese contractor argued that the finality of the disputes clause would deprive him of a constitutional right granted by Article 32 of the Japanese Constitution in that it was intended to oust the jurisdiction of the Japanese courts, and that therefore the clause was void as against the public policy of Japan. The Far Eastern Board of Contract Appeals (FEBCA) agreed that Japanese law controlled but that

<sup>89</sup> *Id.* at 769.

<sup>90</sup> *Id.* at 767.

<sup>91</sup> *But see* *Aktiebolaget Imo-Industri v. United States*, 54 F.Supp. 844 (Ct. Cl. 1944), in which the petition was dismissed because plaintiff, a Swedish corporation, had failed to prove that an American citizen could prosecute a claim against the Swedish Government.

<sup>92</sup> FEBCA No. 88 (1954). See U.S. Dep't of Army, Pamphlet No. 27-153, Procurement Law 270 (1961).

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the question raised by the contractor was one of law which would have to be decided by a court of competent jurisdiction.

Apart from its substance, the wording of the disputes clause presented problems. The language that the decision of the Secretary or his duly authorized representative should be final and conclusive unless determined by a court of competent jurisdiction to have been "fraudulent, or capricious, or arbitrary, or so grossly erroneous as necessarily to imply bad faith,"<sup>93</sup> while perfectly understandable to American contractors in the light of the *Wunderlich* case<sup>94</sup> and its aftermath,<sup>95</sup> inevitably caused raised eyebrows on the part of foreign contractors. "Are American officials, even Secretaries of Departments, so corrupt or flagrantly foolish," they would ask, "that your own Government has to protect us against them? If so, perhaps we had better not deal with them."<sup>96</sup> The ASPR Committee, accordingly, has approved a revised version of the disputes clause which may be used in contracts with foreign firms to be performed outside the United States, under which the offending language is changed to read:

**The decision of the Secretary or his duly authorized representative . . . shall be final and conclusive to the extent permitted by United States law.**<sup>97</sup>

With changes such as these, and the familiarity which comes from experience, foreign contractors have come to accept the disputes clause much more readily. But probably the greatest factor in winning such acceptance has been the establishment of special Boards of Contract Appeals to sit abroad.<sup>98</sup> There is a USAREUR Board of Contract Appeals, sitting in Heidelberg, to hear Army appeals, a USAFE board sitting in Wiesbaden to hear Air Force appeals, and a Far Eastern Board of Contract Appeals sitting in Tokyo. These boards act as the authorized representative of the area commander. For example, the USAREUR board is the authorized representative of the Commander in Chief, USAREUR, in "hearing, considering, and determining all appeals by contractors from decisions on disputed questions by contracting offi-

<sup>93</sup> ASPR 7-103.12(a) (Feb. 15, 1962).

<sup>94</sup> *United States v. Wunderlich*, 342 U.S. 98 (1951).

<sup>95</sup> 68 Stat. 81 (1954), 41 U.S.C. §§ 321, 322 (1958).

<sup>96</sup> See remarks of Mr. Lyttleton Fox, formerly Counsel, European Branch Office of Gen. Counsel, U.S. Dep't of Navy, in *Proceedings of First Summer Conference on International Law*, Cornell Law School, Ithaca, New York, at p. 68 (1957).

<sup>97</sup> ASPR 7-103.12(b) (Feb. 15, 1962).

<sup>98</sup> See Lupton, *European Appeals Boards*, 1 *Government Contracts Rev.* 3 (1957).

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cers.”<sup>99</sup> The Board’s decision is final and conclusive when the amount involved is \$50,000 or less. Above that amount, the contractor may appeal the Board’s decision to the Secretary of the Army (which means, in effect, the Armed Services Board of Contract Appeals). The Board’s authority is limited to deciding appeals on disputed questions of fact. In connection therewith it may consider and decide (although not with finality) questions of law necessary for adjudication of the issue, but it has no jurisdiction over claims for damages based on breach of contract.<sup>100</sup>

The Air Force Boards located abroad have final authority over disputes where the amount claimed is \$25,000 or less. Above that amount the contractor must appeal to the Secretary of the Air Force (which means, in effect, the Armed Services Board of Contract Appeals).<sup>101</sup>

In the ten years between 1951 and 1961, the USAREUR Board and its predecessor, the European Command Board of Contract Appeals, heard about 200 cases. Of these, one-quarter to one-third involved amounts of over \$50,000. Of the latter only four of the Board’s decisions were appealed to the Armed Services Board of Contract Appeals in Washington.<sup>102</sup> These figures do not include the numerous cases in which the dispute was finally settled by the contracting officer (usually on the advice of his legal officer) without any appeal being taken.

In a substantial number of these cases, the USAREUR Board granted the contractor some relief. But about 50% of the appeals resulted in dismissal of the claim. Many of these dismissals were for lack of jurisdiction, in that the contractor was asserting a claim for breach of contract. The Board may, in such cases, make findings of fact, without expressing its opinion on questions of liability.<sup>103</sup> But ultimately such cases have to go to the Court of Claims (or a U.S. District Court), or to the Comptroller General, unless the contractor abandons them. From the contractor’s point of view, this is less than satisfactory.

**3. Arbitration.** The limits on the jurisdiction of a Board of Contract Appeals under the disputes clause, coupled with the expense and difficulty of suing in the U.S. Court of Claims, plus the contractor’s inability to sue the United States in his own courts,

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<sup>99</sup> Hq. USAREUR, U.S. Dep’t of Army, Circular No. 715-50 (July 6, 1957) (Procurement-USAREUR Board of Contract Appeals). In general, see Army Procurement Procedure para. 7-103.12c(2) (Jan. 31, 1962) (hereinafter cited as APP).

<sup>100</sup> *Ibid.*

<sup>101</sup> Air Force Procurement Instruction para. 7-4205.8 (1960).

<sup>102</sup> Information obtained in February, 1961, from President, USAREUR Board of Contract Appeals, Heidelberg, Germany.

<sup>103</sup> See note 99 *supra*.

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raise the question whether more satisfactory measures might not be made available to him. One possibility is arbitration. Foreign contractors are accustomed to arbitration and would prefer it either to the disputes procedure or to litigation. It could be accomplished at the place of contracting and full relief could be given.

A major difficulty is the consistent hostility of the Comptroller General to arbitration. In a series of rulings he has held that the United States may not consent to arbitration in the absence of express Congressional consent.<sup>104</sup> The older court cases are in accord.<sup>105</sup> But the matter need not stop there. There are *dicta* in later court cases which go the other way.<sup>106</sup> The view has been expressed that the United States Arbitration Act<sup>107</sup> could be interpreted to apply to arbitration of at least some Government contracts.<sup>108</sup> In any event, it could be amended or separate legislation enacted to authorize arbitration of Government contracts with foreign contractors to be performed abroad. Finally, it is not clear that the Comptroller's objections are valid in the case of agreements between Governments.<sup>109</sup>

Another problem is, who would do the arbitrating? How could the United States be sure that the arbitrators selected would have sufficient familiarity with United States law and procurement procedures to render sound and practical decisions, and would be sufficiently free from preconceptions favoring foreign business and business methods to render just and fair decisions?

These problems are not insuperable and deserve greater attention than they have thus far received. A good deal of thought

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<sup>104</sup> 32 Comp. Gen. 333 (1963); 8 *id.* 96 (1928); 7 *id.* 641 (1928). The Attorney General has taken the same position. 33 Ops. Atty. Gen. 160 (1922), as has The Judge Advocate General of the Army. Dig. Ops. JAG 1912-40, § 726 (41) (May 6, 1919, and April 14, 1920). See, in general, Braucher, *Arbitration Under Government Contracts*, 17 Law and Contemp. Prob. 473 (1952); Comment, *Validity of Arbitration Provisions in Federal Procurement Contracts*, 60 Yale L.J. 468 (1941). An example of Congressional consent to arbitration is found in § 636 (i) of the Foreign Assistance Act of 1961, 75 Stat. 467, 22 U.S.C. § 2396 (i) (Supp. III, 1962).

<sup>105</sup> *United States v. Ames*, 24 Fed. Cas. (No. 14,441) (C.C.D. Mass. 1846); *McCormick v. United States*, 1 Rep. Ct. Cl. No. 199, 36th Cong., 1st Sess. 1, 44 (1860).

<sup>106</sup> *Aktiebolaget Bofors v. United States*, 194 F.2d 145, 149 (D.C. Cir. 1961). *Cf.* *George J. Grant Constr. Co. v. United States*, 124 Ct. Cl. 202, 109 F. Supp. 246 (1953), 63 Colum. L. Rev. 879 (1953) (Arbitration clause in Commodity Credit Corporation contract held valid).

<sup>107</sup> 9 U.S.C. §§ 1-14 (1958).

<sup>108</sup> Braucher, *op. cit. supra* note 104, at 475-77.

<sup>109</sup> *Cf.* Carabiber, *L'Evolution de l'Arbitrage Commercial International*, 99 *Recueil des Cours* 118, 176-81 (Hague Academy of International Law, 1960); Simpson & Fox, *International Arbitration*, c. 3, pp. 42-46 (1959).

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has been given to arbitration as a means of settling disputes in private foreign trade,<sup>110</sup> and in foreign trade engaged in by the state trading entities of other countries,<sup>111</sup> but not nearly enough in the area of United States Government foreign contracting.<sup>112</sup>

There are, however, a few straws in the wind. The Economic Aid Agreement between the United States and Spain<sup>113</sup> has two references to arbitration: (1) Article III(c) provides that claims by the United States against Spain arising out of the guaranty programs which cannot be settled by mutual agreement will be submitted to arbitration, and if the two Governments cannot agree on the selection of an arbitrator, he may be designated by the President of the International Court of Justice at the request of either Government; (2) Article IX states that both Governments agree to submit to the decision of the International Court of Justice, or of a court of arbitration or arbitral tribunal to be mutually agreed upon, any claim espoused or presented by either Government on behalf of one of its nationals arising as a consequence of governmental measures taken after April 3, 1948, by the other Government and affecting property or interest of such national, including contracts with or concessions granted by the duly authorized authorities of such other Government."<sup>114</sup> These provisions of the Economic Aid Agreement are not, however, expressly carried over to the terms of the Defense Agreement<sup>115</sup>

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<sup>110</sup> See International Trade Arbitration (Domke ed. 1958); Kopelmanas, *The Settlement of Disputes in International Trade*, 61 Colum. L. Rev. 384 (1961); Domke, *The United Nations Conference on International Commercial Arbitration*, 53 Am. J. Int'l L. 414 (1959); Domke, *The Settlement of Disputes in International Trade*, 1959 U. Ill. L.F. 402; Czyzak & Sullivan, *American Arbitration Law and the U.N. Convention*, 13 Arb. J. (n.s.) 197 (1958).

<sup>111</sup> Domke, *Arbitration of State-Trading Relations*, 24 Law & Contemp. Prob. 317 (1959); Hazard, *State Trading and Arbitration*, in International Trade Arbitration, *supra* note 110, at 93-100; Fensterwald, *The Effect of State Trading Upon Arbitration*, 5 Arb. J. (n.s.) 163 (1950).

<sup>112</sup> But see Panel Discussion, *Arbitration Between Governments and Foreign Private Firms*, 1961 Proceedings, Am. Soc'y Int'l L. 69-77; *Report of Committee on International Commercial Arbitration*, Proceedings and Committee Reports, Am. Branch, Int'l L. Ass'n 84-87 (1959-60).

<sup>113</sup> Sept. 26, 1953, 4 U.S.T. & O.I.A. 1903, T.I.A.S. No. 2851, 207 U.N.T.S. 93.

<sup>114</sup> Under Article IX(1), however, the United States reserves its rights under the Connally Amendment (61 Stat. 1218 (1946), T.I.A.S. No. 1598, 1 U.N.T.S. 9) with respect to the compulsory jurisdiction of the International Court of Justice. An Interpretative Note (Annex, para 8), states that any agreements under Article IX(1) (presumably agreements on the choice of arbitrators) would be subject to approval by the U.S. Senate.

<sup>115</sup> Mutual Defense Assistance Agreement With Spain With Tax Relief Annex and Interpretative Note in Regard to Tax Relief Annex, Sept. 26, 1953,

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or of the Agreement on Offshore Procurement<sup>116</sup> with Spain.

The wording of the Spanish agreement suggests, albeit obliquely, the availability of the arbitration facilities of the Permanent Court of Arbitration at The Hague, which is distinct from the International Court of Justice, but not intended to compete with it.<sup>117</sup> Although the latter hears only cases between states and international entities, the former is not so limited. Moreover, it can engage in conciliation procedures, as well as arbitration in the strict sense. As the Secretary General of the Permanent Court of Arbitration has pointed out:

There is a possibility of bringing before the Court of Arbitration disputes between States and private persons, especially between States and important commercial corporations. It is well known that the International Court of Justice could not be seized of disputes of that kind, since its jurisdiction is limited to those between States. It can only treat a difference between a State and a private person or a foreign commercial corporation in case the State itself espouses the respective dispute. For the Court of Arbitration this indirect way is not necessary.

If one considers the fact that States are, generally speaking, little disposed to submit their differences to arbitration, one cannot deny that the conciliation procedure might become one of the means contributing to finding solutions acceptable to both litigating parties.<sup>118</sup>

Certainly, conciliation or arbitration under the aegis of such a body as the Permanent Court of Arbitration should allay any fears on the part of the United States that its interests would not be adequately protected.

Finally, the traditional objections to arbitration do not apply where the United States is not a direct party to the agreement. For example, contracts between the NATO Maintenance Supply Service Agency (NMSSA) (which is a NATO "subsidiary body" under the Ottawa Convention of September 20, 1951<sup>119</sup>) and private concerns contain an arbitration clause. The United States is a member and a substantial contributor to NATO and therefore

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4 U.S.T. & O.I.A. 1876, T.I.A.S. No. 2849, 207 U.N.T.S. 61; Defense Agreement With Spain, Sept. 26, 1953, 4 U.S.T. & O.I.A. 1895, T.I.A.S. No. 2850, 207 U.N.T.S. 83.

<sup>116</sup> Agreement Relating to Offshore Procurement in Spain, *supra* note 44, as extended and amended, Oct. 26, 1954, 5 U.S.T. & O.I.A. 2357, T.I.A.S. No. 3094, 235 U.N.T.S. 66; Dec. 21 and 27, 1956, 7 U.S.T. & O.I.A. 3460, T.I.A.S. No. 3721; Oct. 29 and Nov. 11, 1958, 10 U.S.T. & O.I.A. 344, T.I.A.S. No. 4196, 341 U.N.T.S. 400. This agreement does, however, refer to Art. II(1)(e) of the Economic Aid Agreement with Spain, *supra* note 113, which relates to encouragement of trade between the two countries.

<sup>117</sup> See *Permanent Court of Arbitration*, Circular Note of the Sec'y Gen., March 3, 1960 [Unofficial Translation], in 54 Am. J. Int'l L. 933 (1960).

<sup>118</sup> *Id.* at 937-39.

<sup>119</sup> Agreement on the Status of the North Atlantic Treaty Organization, National Representatives, and International Staff, Sept. 20, 1951, art. 1(c) [1954] 5 U.S.T. & O.I.A. 1087, T.I.A.S. No. 2992, 200 U.N.T.S. 3.

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pays a portion of the cost of performing contracts entered into by NMSSA. But it is not a party to such contracts. On March 9, 1960, the North Atlantic Council, the United States concurring but not taking the initiative, approved the inclusion of an arbitration clause in the standard form of NMSSA contract.

The same policy has since been followed in contracts by other NATO subsidiary bodies, and in contracts under cooperative arrangements, such as the Weapons Production Program, to which the United States is a contributor but not a party.

### D. TAX RELIEF

Section 521 of the Mutual Security Act of 1951 provided as follows:

**Funds made available for carrying out the provisions of Title I of this Act shall be available for United States participation in the acquisition or construction of facilities in foreign countries for collective defense: *Provided*, That no part of such funds shall be expended for rental or purchase of land or for payment of taxes.<sup>120</sup>**

Although this was construed as applying by its terms only to funds for support of the infrastructure program,<sup>121</sup> it was determined administratively that the same policy should be applicable to all defense expenditures in foreign countries, including offshore procurement."<sup>1</sup>

A Working Group on European Tax Relief was established by the interested Government agencies, and this group set about negotiating tax agreements with the countries concerned. As a practical matter, it was decided that the taxes for which relief should be sought (1) must be readily identifiable in the normal course of business, and (2) must not be so low in incidence as to be *de minimis*.<sup>123</sup>

The agreements finally negotiated covered taxes on expenditures for (a) infrastructure, (b) facilities for use of the United States Forces, and (c) offshore procurement, both DOD-OSP and MAP-OSP.<sup>124</sup> In the early part of 1951, tax agreements were secured with nine Western European countries. Later, agreements were negotiated with other countries.<sup>125</sup> Since the tax structure of

<sup>120</sup> 65 Stat. 384 (1951). This became § 104(c) of the Mutual Security Act of 1954, 68 Stat. 834. Apparently it has not been carried forward into the 1961 Act.

<sup>121</sup> Efron & Hill, *Foreign Taxes on United States Expenditures*, 23 U. Cinc. L. Rev. 371, 385-89 (1954).

<sup>122</sup> *Id.* at 389-90.

<sup>123</sup> *Id.* at 391.

<sup>124</sup> *Id.* at 393.

<sup>125</sup> *Id.* at 400-01.

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each of these countries differ widely, no two agreements are alike. However, there is a basic pattern which runs throughout.

Net income taxes were not regarded as within the framework of tax relief. (But gross income taxes might be a different matter, as amounting essentially to a sales tax.) Similarly, real property taxes were exempted from the operation of the agreements. Social security contributions were regarded as exempt. Local service charges, so long as they were not a disguised form of taxation, were also exempted.<sup>126</sup>

This left, as the major area to which tax relief applied, export and import duties, and the various types of sales, use, construction, transactions, production, services, and miscellaneous taxes.<sup>127</sup> Since these are protean in their forms, and since they are imposed at every stage of the production and manufacturing process, the final impact on the ultimate consumer often being obscure, the working out of these agreements, and even more their implementation, was a difficult task.

Since the Netherlands agreements have been chosen as examples in other areas, a brief outline of the US.-Netherlands Tax Agreement of March 7, 1952,<sup>128</sup> might be of interest.

(a) The "Memorandum on Tax Relief," as it is called, first states that tax relief will be granted on expenditures by the United States in the Netherlands for the common defense effort, including expenditures for any foreign aid program.

(b) Such tax relief applies to (1) turnover taxes, and (2) import taxes and duties, insofar as such relief would be accorded if the articles were exported from the Netherlands, whether or not they are in fact exported.

(c) Social security and similar contributions are not affected.

(d) (1) In direct Government-to-Private-Contractor contracts, payments thereunder by the United States will be net of duties and taxes; (2) wherever the Netherlands Government acts as procuring agency, the reimbursement from the United States to the Netherlands Government will be net of duties and taxes; (3) if for technical reasons relief cannot be afforded by way of tax exemption, as in the case of the infrastructure program, the Netherlands Government will bear the burden of all such taxes.

(e) There may be further discussions between the two Governments on additional types of taxes not covered by the Memorandum, but which should be brought under the principles thereof.

<sup>126</sup> *Id.* at 394-97.

<sup>127</sup> *Id.* at 399-412.

<sup>128</sup> Agreement Relating to Relief from Taxation, *supra* note 33.

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Implementation of the tax agreements has been, in general, three-fold :

(a) Clearly identifiable taxes are excluded from the contract price ;

(b) Legislation has sometimes been enacted by the Government concerned granting tax exemption ;

(c) Where the taxes are not readily identifiable, as where taxes have been imposed on early stages of production, a determination is made by the Government concerned as to its best estimate of the percentage of the final contract price which represents taxes ; this amount is refunded by the Government to the contractor and the amount thereof is passed on to the United States or deducted from the contract price.

Of these, (a) has presented no special problems, and (b), where available, has proved preferable to (c).

Another technique which was followed in the early days, before the tax agreements were worked out, was for the United States to withhold a stated percentage to cover taxes, usually **30%** of the contract price, the exact amount to be subsequently adjusted. This proved to be unworkable because it discouraged contractors from bidding, or it induced them to inflate their bids by including a contingency factor to cover the withholding.

ASPR ¶ 11-403.2 sets forth the forms of contract clauses required to be used in any country where a tax agreement is in effect. Where there is no relevant tax agreement, ASPR ¶ 11-404 requires that any available tax benefits be explored and given specific treatment in the contract, and prescribes a clause which states that, except as otherwise provided, the contract price includes any and all applicable taxes. In such cases Army Procurement Procedures require that the contracting officer include in the contract file detailed information concerning the specific taxes and amounts, normally applicable to the transactions, from which contractors may nevertheless be **exempt**.<sup>129</sup>

In January, 1960, the Comptroller General submitted a report to Congress entitled "Review of Administration of Tax Exemption Privileges under the Offshore Procurement Program." He pointed out that in many instances the military services had failed to take full advantage of the exemptions available under the tax agreements. As a result of selected examinations by the military auditing agencies, some made with the assistance of the Comptroller General, about \$825,000 of taxes erroneously paid had been refunded, claims had been made against contractors for an addi-

<sup>129</sup> APP 11-404.50 (Jan. 31, 1962).

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tional \$1,013,000, and an estimated \$1,000,000 of erroneous payments was considered uncollectible because of failure of contracting officers to document their files adequately. The preponderance of recoveries and claims involved Army contractors. (In fairness, it should be pointed out that the Army had the principal responsibility for offshore procurement in Europe and made the bulk of the purchases. It should also be pointed out that most of the recoveries and claims dated back to the period 1952-1953, when the offshore procurement program was still new and before much experience had been acquired in implementing the tax relief agreements).

The Comptroller recommended that the Department of Defense promulgate procedures requiring that the nature and specific amounts of taxes excluded from prices of offshore procurement contracts be made part of the contract negotiation files by contracting officers. This has been done and the required procedure is set forth in ASPR ¶ 11-403.1(b).

A recent decision of the Armed Services Board of Contract Appeals, *Breda Electromeccanica e Locomotive*,<sup>130</sup> illustrates the operation of some aspects of the tax relief procedures. In 1953 the Navy entered into an ammunition contract with appellant, an Italian concern, at an aggregate price of \$15,660,000. The contract price excluded taxes and duties otherwise assessable on the final transfer of the ultimate end product, but presumably included an unascertained amount of taxes and duties which might have become incorporated in the contractor's costs in the chain of acquisition and processing of parts and materials going into the end product. These were of two types: (1) "Imposta Generale sull'Entrata" (IGE), a kind of sales tax, and (2) customs duties. In accordance with existing procedures under the United States-Italy tax agreement, known as the Dunn-Vanoni Agreement,<sup>131</sup> the Italian Government had, prior to the date of the contract, certified that the amount of such "built-in" IGE was 1.5% of the United States contract price, and the amount of built-in customs was 1.39%, a total of 2.89%. The Italian Government was obligated to refund this amount to the contractor, and the latter deducted it from his invoices to the United States. After the date of the contract, but before deliveries thereunder had been completed, the Italian Government made a series of new determinations, the final effect of which was to increase the IGE figure to

<sup>130</sup> ASBCA No. 4801 (Nov. 30, 1960), 61-1 B.C.A. ¶2871, *motion for reconsideration denied*, Mar. 31, 1961, 61-1 B.C.A. ¶3010.

<sup>131</sup> Agreement Relating to Relief from Taxation of United States Expenditures in Italy for the Common Defense [Exchange of Notes], March 5, 1952, 3 U.S.T. & O.I.A. 4234, T.I.A.S. No. 2566, 179 U.N.T.S. 3.

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3% and to decrease the customs figure to 1.02%, a net increase from 2.89% to 4.02%.

The contracting officer claimed that the United States was entitled to an additional price reduction of 1.5% on account of the increase in the IGE percentage but was not required to give any credit for the decrease in the customs percentage. The contractor argued (1) that no reduction was in order, because the original deduction of 2.89% exceeded the refunds it had actually received from the Italian Government; (2) that it was at least entitled to be credited with the difference between the original deduction and the amount of refunds it had received; and (3) that in no event should the overall price reduction exceed 4.02%, the sum of the adjusted IGE percentage and of the adjusted customs percentage.

The Board upheld the third contention of the contractor, rejecting the argument of the contracting officer that the adjustment was a "one-way street." The Board rejected the first two contentions of the contractor, observing that the amount of refund to which it was entitled was a matter between it and the Italian Government. On motion for reconsideration the contractor argued that the Italian Government had applied the new rate of refund only to subsequent deliveries. Again the Board held that this was a matter between the contractor and the Italian Government. The Dunn-Vanoni Agreement was conclusive on all these points. It made the Italian Government the sole judge of the amount of any built-in IGE and customs and consequently of the quantum of dollar reduction in the contract price, and its determination was binding on both parties.

### E. NO-PROFITS CLAUSE

Each of the Memoranda of Understanding includes a clause to the effect that it is the intention of the parties that no profit of any kind will be made by the foreign government on offshore procurement contracts placed on a Government-to-Government basis. The principal concern at the outset was gain on fluctuation of exchange rates and this is specifically referred to in most of the Memoranda. But other problems, not so simple of solution, have arisen which are not clearly covered by the wording of the Memoranda.

Actually, the choice of the word "profits" was unfortunate. No government likes to be accused of making a "profit," even inadvertently, and the instinctive reaction of a foreign minister is to deny indignantly that any such thing has occurred. The U.S.-U.K. Memorandum of Understanding<sup>132</sup> avoids the use of this word,

<sup>132</sup> U.S. Dep't of Army, Pamphlet No. 27-150, *supra* note 31, at 307.

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referring instead to an "excess of receipts from the agreements between the two Governments covered by this Memorandum over the costs of performing them."

The U.S.-U.K. agreement further makes clear that in the computation of any excess receipts to be refunded, "the agreements between the two Governments covered by this Memorandum shall be considered collectively and not individually." The same general provision appears in most of the other agreements, and in all cases has been accepted as a governing principle.

The most difficult problem in implementing the No-Profits Clause has been the question of profit accruing to Government owned or controlled enterprises. In this country it is customary to think of Government corporations, such as the Reconstruction Finance Corporation, as mere arms of the government, organized in corporate form for the sake of convenience. In Europe, it is not so simple. Not only are utilities and railroads commonly Government owned, but in many countries numerous businesses of an essentially commercial character are owned in whole or in part by the Government. Automobile manufacturing concerns and shipbuilding plants are common examples. These companies are run exactly like private concerns and often compete with the latter in the same line of business. To complicate matters still further, Government ownership may be less than complete. Sometimes the fact of partial Government ownership is not generally known.

To the European mind, accustomed to this arrangement, these enterprises are separate corporate entities, in no way to be confused with the Government, engaged in business for a profit like any other businesses. They look to their profits, as do private concerns, for funds for expansion, for reserves against subsequent losses, and so on.

In many of the shipbuilding contracts placed before the effective date of a Memorandum of Understanding, in Italy for example, this approach was accepted and a profit element was reflected in the contract price, although the rate of profit was limited to an agreed percentage, say 8%, any profits in excess of that amount to be refunded.

But as to contracts governed by the Memoranda of Understanding, the United States has taken the position that any profit to a Government owned corporation (or in case of a partially owned corporation, that portion of the profit which accrues to the Government) is a profit to be refunded to the United States. In one or two countries, the United States position has been accepted, but in most

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it has been strenuously opposed. So far as is known, the question has not yet been resolved.

Despite all these difficulties, substantial progress has been made in implementing the No-Profits Clause. In 1955, the Secretary of Defense appointed Mr. Warren E. Hoagland, a civilian attorney, as a special assistant to Mr. John Haskell, then Defense Representative to the North Atlantic and Mediterranean Area, to make an independent study of this matter. In 1958 a Joint Staff Group representing the Departments of Defense and State made a study of the entire profit recovery project, in cooperation with Mr. Hoagland.

On June 30, 1958, Mr. Hoagland submitted a report<sup>133</sup> in which he concluded that most of the major objectives of the profit recovery program had been achieved, and most of the problems and conflicts resolved. Negotiations had advanced to a large degree and orderly procedures and principles had been established for their early completion. There was no evidence or suggestion of corruption, wrongdoing, fraud, or profiteering, or of any violations of law.

The report reviewed at some length the problem of the Government owned or controlled corporation. Although this problem existed in many countries, it was found to be of serious consequence only in Italy, Spain, and France, especially the two former.

The negotiations for profit refunding are conducted in each country through the United States Embassy, under the supervision of the American Ambassador and under joint instructions from the Departments of Defense and State. Military procurement officials, the Hoagland Report pointed out, play an important role, not only in furnishing information, but in avoiding the problem in the first instance by negotiating contracts with due regard to the no-profits principle. No instance was found of a direct Government-to-Government contract which allowed or contemplated any profit. Because of this factor, coupled with the collective principle and the problem of increasing costs, actual refunds are not expected to be exactly astronomical in amount. It is understood that, as of a year ago, a substantial refund could be expected from only one country, in the amount of about \$12,000,000 and even this amount may be reduced by a possible loss on one large contract still outstanding.

### F. OTHER PROBLEMS

Space does not permit of more than a listing of some of the other legal problems which have arisen in the area of offshore pro-

<sup>133</sup> Hoagland Report, *supra* note 5. Although parts of this report are classified, references are made herein only to the unclassified parts.

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curement, or which present unusual features not found in domestic procurement. Among these are the effect of the antitrust laws **abroad**,<sup>134</sup> negotiation versus **advertising**,<sup>135</sup> debarred bidders, defaults and delays by contractors, escalation (especially in the case of statutory increases in labor rates), payment in local currency and use of "counterpart" funds, procurement by **barter**<sup>136</sup> and disposal of agricultural **surpluses**,<sup>137</sup> placement and performance of subcontracts, **renegotiation**,<sup>138</sup> plant security and subversive activities, and transfers and use of equipment procured **for** military assistance purposes. **Of** special interest is the whole area of acquisition and interchange of patent rights and technical information. But this is a matter which concerns military assistance in general, not merely offshore procurement. It has been quite extensively covered by other **writers**<sup>139</sup> and a cursory treatment herein would add nothing to what has already been said so well.

<sup>134</sup> See, e.g., Haight, *The Sherman Act, Foreign Operations, and Znternational Law*, in *Legal Problems in International Trade and Investment* 89-109 (Shaw ed. 1962); Fugate, *Enforcement of the United States Antitrust Laws in Foreign Trade*, 5 A.B.A. Sec. Int'l & Comp. L. Bull. 20 (1960); Dewey, *Antitrust Barriers to Foreign Policy Goals*, 33 N.Y.S.B.J. 21 (1961). Cf. *In re* Grand Jury Investigation of Shipping Industry, 186 F.Supp. 298 (D.D.C. 1960), 55 Am. J. Int'l L. 489 (1961).

<sup>135</sup> The Armed Services Procurement Act permits negotiation if the contract is for "property or services to be procured and used outside the United States, and the Territories, Commonwealths and possessions." 10 U.S.C. § 2304(a) (6) (1958).

<sup>136</sup> See Pendleton, *Barter—A New Approach to Government Procurement*, 22 D.C. Bar Ass'n J. 11 (1955).

<sup>137</sup> Agricultural Trade Development and Assistance Act of 1954, 68 Stat. 454, as amended, 7 U.S.C. §§ 1691-1724 (1958), 7 U.S.C. §§ 1694-1697, 1701(f), 1703(b), 1704(a), (b), (e), (k), (o)-(s), 1704b, 1706, 1709, 1721-1724, 1731-1736 (Supp. 111, 1962); Exec. Order No. 10900, as amended, 26 Fed. Reg. 143, 781, 811, 10469 (1961).

<sup>138</sup> Section 106(a) (1) of the Renegotiation Act of 1951, as amended, exempts contracts with foreign governments or agencies thereof. 65 Stat. 17 (1951), 50 U.S.C. App. § 1216(a) (1) (1958). Section 106(d) (1) of the Act authorizes the Renegotiation Board, in its discretion, to exempt any contract or subcontract to be performed outside the continental United States. 65 Stat. 19 (1951), 50 U.S.C. App. § 1216(d) (1) (1958). Pursuant to the authority, the Board has granted an exemption from renegotiation for contracts and subcontracts wholly performed outside the United States, subject to certain limitations and qualifications. Renegotiation Board Regulations under the Renegotiation Act of 1951, § 1455.2, 32 C.F.R. § 1455.2 (1954, Supp. 1961).

<sup>139</sup> See Cardozo, *Exchange of Patent Rights and Technical Information Under Mutual Aid Programs*, Study No. 10 of Subcomm. on Patents, Trademarks, and Copyrights, Senate Comm. on Judiciary, 85th Cong., 2d Sess. (1958); Rodriguez and others, *Patent and Technical Information Agreements*, Study No. 24 of Subcomm. on Patents, Trademarks, and Copyrights, Senate Comm. on Judiciary, 86th Cong., 2d Sess. (1960); Westerman, *Znternational Exchange of Patent Rights and Technical Information for Defense Purposes*, 21 Fed. B. J. 152 (1961); Robillard, *Governmental Patent Administration, Policy and Organization*, 1 Pat., T.M. & Copyright J. of Res. & Ed. 270, 278-81 (1957).

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Overriding all legal and technical problems are three primary problems which should never be forgotten but are often ignored:

First, there is the problem of communication. The language barrier is a difficult one but is only part of the problem. Even when documents are accurately translated and skilled interpreters are used, the same phrase may mean two quite different things in two different legal systems. Even as between the United States and the United Kingdom, sharing a common language and a common-law heritage, this can happen.

Secondly, every country has its own way of doing business. This simple fact is sometimes hard for the American representative to comprehend. Too often he assumes that the American way is necessarily superior. Or, if he does become accustomed to business methods in country X, he naively assumes that the same methods will be followed in country Y.

Finally, and closely allied to both the foregoing, has been an over-rigid insistence on United States procurement regulations and contract clauses. When these are required by statute, there is perhaps no practical alternative, but in other cases it has done a great deal of harm, especially at first. Experience has brought home the fact that there must be leeway to deviate from strict ASPR requirements and forms, so long as no essential interest of the United States is sacrificed. This is now recognized in the ASPR itself and the situation is much more satisfactory than it was. But here, as in so many other areas, the United States seemed determined to learn the hard way.

### V. LATER DEVELOPMENTS

This article has been concerned, in the main, with the subject of offshore procurement in its simplest form, the purchase of equipment, supplies and services abroad. To a large extent this is now a matter of history. While offshore procurement in this sense still continues and is substantial in amount, to some extent it has been supplanted by more complex forms of procurement, on a mutual or cooperative basis. But these can hardly be understood without a preliminary explanation of offshore procurement, which is the primary purpose of this article. Two of these new forms will be mentioned briefly, but adequate treatment would have to be the subject of a separate article or articles.

#### A. WEAPONS PRODUCTION PROGRAM

This program had its antecedents in the Special Facilities Assistance Program and the Mutual Weapons Development Pro-

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gram (formerly known as the Special Weapons Program), both begun in fiscal year 1954.<sup>140</sup> But it differs from both of these programs, as well as from the offshore procurement program itself, in being much more of a mutual and cooperative enterprise. It began in December 1957 at the meeting of the NATO Heads of Government in Paris, at which the late Secretary of State Dulles offered to make available to other NATO nations American technical knowledge and experience in the manufacture of modern weapons. In effect, the results of billions of dollars of American investment in research and development were to be made available to European industry under a cooperative program of manufacture and production.

The Congressional policy favoring coordinated procurement was set forth in Section 105(b) (1) of the Mutual Security Act of 1954, which provided in part :

The Congress believes it essential that this Act be so administered as to support concrete measures to promote greater political federation, military integration, and economic unification in Europe, including coordinated production and procurement programs participated in by members of the North Atlantic Treaty Organization to the greatest extent possible with respect to military equipment and materials to be utilized for the defense of the North Atlantic area.<sup>141</sup>

In somewhat different form, the same idea appears in Sections 602 and 503 of the Foreign Assistance Act of 1961.<sup>142</sup>

The implementation of this program is complicated but can be outlined briefly as follows. First, on an overall basis, the United States has entered into a series of Weapons Production Programs Agreements with various NATO countries,<sup>143</sup> superseding the older Facilities Assistance Program Agreements and Special Weapons Agreements.

For each specific project the participating governments set up an intergovernmental Production Organization, with a Board of Directors and a Program Office. The Board of Directors selects a prime contractor for each participating nation and approves the allocation of production among the selected contractors. On the industrial side, in the first such program the prime contractors pooled their efforts for overall management by organizing a corporation under French law to act as a coordinating superstructure.

<sup>140</sup> See § 542 of the Mutual Security Act of 1951, as added by § 301 of the Mutual Security Act of 1953, 67 Stat. 153; Mutual Security Appropriation Act of 1954, 67 Stat. 478, 479 (1953). See also S. Rep. No. 1799, 83d Cong., 2d Sess. (1954), in 1954 U.S. Code Cong. & Ad. News 3175, at 3242-44, 3263.

14168 Stat. 836 (1954), as amended, 69 Stat. 284 (1956). Statutory authority for this program was found in section 102 of the same act.

<sup>142</sup> 75 Stat. 434, 435 (1961), 22 U.S.C. §§ 2301, 2311 (Supp. 111, 1962).

<sup>143</sup> See, e.g., Agreement With France Relating to a Weapons Production Program, Sept. 19, 1960, 11 U.S.T. & O.I.A. 2333, T.I.A.S. No. 4611.

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Somewhat different arrangements were adopted for subsequent programs.

Each participating nation agrees to purchase a share of the end product, roughly proportionate to its share in production. The United States also agrees to purchase a share of the end product. Under the first program this was done by entering into a regular offshore procurement contract with the Production Organization. In subsequent cases this was accomplished by entering into a barter arrangement.

These manifold agreements are reflected in a series of multi-lateral agreements, known as "Technical Arrangements," by and among the United States, the participating governments, and the Production Organization, which cover all general matters (taxes, patent rights, licenses, know-how, and the like), and, in separate appendices, spell out (1) the procurement obligations of the United States and of the participating governments; (2) the amount of grant assistance to be provided by the United States; (3) the amount of reimbursement assistance to be provided by the United States; and (4) security matters. Reimbursement is accomplished by giving a credit to the United States against obligations under its procurement commitment for the end product. The United States makes a separate arrangement with an American prime contractor for the furnishing of necessary data, technical information and know-how to the European prime contractors, and the American prime contractor enters into the necessary agreements with the European coordinating corporation.

The first Weapons Production Program was the HAWK program, covering the production of a surface-to-air missile, in a total amount of about \$500,000,000, of which the United States is furnishing \$40,000,000 in grant aid and up to \$60,000,000 in reimbursable aid. The second was the SIDEWINDER program, covering production of an air-to-air guided missile, and the third the F-104G Starfighter Jet Program, costing more than \$1,000,000,000. Others are the "Atlantique" Maritime Patrol Aircraft Program and the Mark 44 Torpedo Program. Some twenty other projects are under consideration or in the preliminary stages.<sup>144</sup>

Obviously this is an extremely complex program, bristling with legal problems, only the bare outlines of which are set forth above.<sup>145</sup>

<sup>144</sup> See *N.Y. Times*, May 26, 1961, pp. 11, 14 (international ed.)

<sup>145</sup> For a more complete explanation, see Address by Lieutenant Colonel George F. Westerman, JAGC, U.S. Army, *The Lawyer's Role in the NATO Production of Weapons*, 1960 Judge Advocates Conference, Judge Advocate General's School, U.S. Army, Charlottesville, Virginia, from which most of the above information is taken.

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### B. JOINT FLEET MODERNIZATION

This is a cost-sharing program under which the United States agrees, on a dollar-for-dollar basis, to cooperate with a foreign country in a shipbuilding program under the applicable Mutual Defense Assistance Agreement. A typical example is the 1960 Agreement with **Norway**.<sup>146</sup> Under this the Government of the United States agreed to contribute up to \$3,000,000, contingent on the obligation of such sum by appropriate contracts prior to a specified date, and the Government of Norway agreed to contribute an equal amount, subject to the availability of appropriations. The Government of Norway agreed that its contribution would be over and above its normal allocation of funds for construction, operation, maintenance, and training of its defense forces. In carrying out this program, the two Governments agreed to enter into supplementary arrangements, through their appropriate contracting officers, covering the specific vessels involved, setting forth the amounts of the respective contributions for each vessel, the time phasing for delivery, and other appropriate details.

### VI. CONCLUSION

Despite its weaknesses and faults, the offshore procurement program has proved to be a success. Much of it has passed into history, to be succeeded by newer and more intricate arrangements, which would have been unthinkable in the absence of the experience gained in the early stages. Only a decade ago, the program hardly existed. In a remarkably short space of time the Departments of State and Defense, with the help of other agencies, successfully got under way an international program of mutual defense assistance unlike anything that had been undertaken in prior history. In this the military procurement activities, aided by their lawyers, played a major, if not the major, role. Many mistakes were made; much money was wasted. But to concentrate on these, while losing sight of the overall achievement, is to miss the forest for the trees.

A critical analysis made in 1957 by a naval officer with experience in the field is worth quoting.<sup>147</sup> Although he found much to criticize, his overall observation was as follows :

**The most striking feature of the Offshore Procurement Program during the period from 1952 through 1956 was the fact that it was a purchasing operation that worked so well. Using the professional yardsticks of de-**

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<sup>146</sup> Agreement Relating to a Shipbuilding Program for the Norwegian Navy [Exchange of Notes], July 6, 1960, 11 U.S.T. & O.I.A. 1796, T.I.A.S. No. 4522.

<sup>147</sup> Starr, *A Critical Analysis of Five Years of Military Procurement in Europe*, May 27, 1957, on file in the Office of Naval Material, U.S. Navy Dep't, Washington, D.C.

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livery at reasonable price at or near the date required with a minimum of failures represented by either emergency U.S. Government financing, terminations for default or non-acceptance of product the Offshore Procurement Program was unbelievably successful. This result was obtained in spite of the fact that the venture was politically conceived as an alternative to earlier unsatisfactory methods of funding European countries in mutual defense efforts; was placed in operation without adequate advance planning; was underestimated both as to magnitude and as to duration by the Military Departments; and, was rigidly restricted in operation by the assumption, later proved erroneous, that business and industrial structures and practices throughout the world were necessarily the same as those in the United States so that procurement regulations applicable within the United States would automatically be appropriate in Offshore Procurement.<sup>148</sup>

From a broader standpoint, the arrangements made, the contracts entered into, and the experience gained have made a real contribution to the development of international and "transnational" law in its practical, down-to-earth applications. As Professor Wolfgang Friedmann has said, in a slightly different context, but in words which seem equally applicable here :

We shall also have to look at the large number of bilateral concession agreements between a sovereign government and a foreign investor for the slow and halting development of international legal principles governing international investment. The first—and cardinal—principle—yet far from established—is that agreements between a government—or a government-controlled corporation—and a foreign private investor should come to be controlled by firm legal principles, modeled on the general principles of law—and, in particular, of contract—as recognized by civilized nations. This would be part of the increasing blending between public law and private law in the field of international economic transactions.<sup>149</sup>

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<sup>148</sup> *Ibid.*

<sup>149</sup> Friedmann, *Changing Social Arrangements in State-Trading States and Their Effect on International Law*, 24 *Law & Contemp. Prob.* 350, 365 (1959).

# BID GUARANTEES IN FEDERAL PROCUREMENT \*

BY ROBERT H. RUMIZEN\*\* AND MILTON J. SOCOLAR\*\*\*

## I. INTRODUCTION

Where public contracts are awarded under competitive bidding procedures, the Federal Government, pursuant to applicable statutes and regulations, holds out that it will make award to that responsible bidder whose bid, conforming to the invitation for bids, will be most advantageous to the Government, price and other factors considered, or that it will reject all bids and readvertise.<sup>1</sup> Agents of the Government have no discretion in this regard. Since the Government obligates itself to award its contracts upon an objective basis without favor to any particular bidder, it is clearly the duty of each bidder to enter into a formal contract if his offer is accepted within its terms. As stated by the Court of Claims in *Scott v. United States*,<sup>2</sup>

The agents of the Government stand upon a different footing from private individuals in the matter of advertising for the letting of contracts in behalf of the United States. They have no discretion. They must accept the lowest or highest (in the case of sales) responsible bid, or reject all and readvertise. Private individuals are not required thus to act. Hence it is apparent that government agents should be allowed a reasonable time after the opening of bids before they are allowed to be withdrawn, so they can be afforded opportunities to ascertain whether collusion or fraud has been perpetrated against the United States by the parties engaged in the bidding.<sup>3</sup>

\* The opinions and conclusions presented herein are those of the authors and do not necessarily represent the views of the General Accounting Office, The Judge Advocate General's School or any other governmental agency.

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<sup>1</sup> Federal Property and Administrative Services Act of 1949, § 303, 63 Stat. 396, 41 U.S.C. § 263 (1968); 10 U.S.C. § 2306 (1958); Federal Procurement Regs. § 1-2.101 (1960); Armed Services Procurement Reg. para. 2-101 (IV) (July 1, 1960) (hereinafter referred to as ASPR); *Scott v. United States*, 44 Ct. Cl. 624, 627-28 (1909).

<sup>2</sup> *Scott v. United States*, supra note 1.

<sup>3</sup> *Id.* at 527.

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Although a successful bidder's refusal to enter into a formal contract would not necessarily relieve him of liability were the Government to accept his bid and make award, the costs and administrative difficulties to the Government in obtaining performance or damages from a recalcitrant bidder are burdensome. To assure ultimate execution of a contract and to protect the Government against the consequences of unjustifiable failure or refusal to enter into a final or formal contract, the Government often requires a deposit or security to accompany each bid.<sup>4</sup> Generally, bid guarantees are called for by the Government only where the invitation for bids also requires the furnishing of payment or performance bonds. The act of furnishing a bid guarantee would not, however, ratify requirements as to the bidder's responsibility; it would still be the duty of Government authorities to take into consideration matters bearing on the likelihood of prompt and efficient contract performance.<sup>5</sup>

Bid guarantee requirements are imposed by statute on the Post Office Department with respect to bids for transporting the mail and on the Public Printer with respect to the furnishing of paper and envelopes.<sup>6</sup> No other agency of the Federal Government has bid guaranty requirements imposed upon it by statute; bid security is virtually entirely a matter of administrative procurement regulation.

Regulations governing bid guarantees have been promulgated pursuant to applicable law by the Department of Defense and the General Services Administration.<sup>7</sup> These regulations are substantially identical in that they provide for advising prospective bidders, where a bid guarantee has been determined to be necessary, that failure to comply with guarantee requirements in the proper amount by the time set for public opening of bids may be cause for rejection of a bid. Waiver of bid guarantee requirements is permitted in only four specified situations.<sup>8</sup>

The purpose of this article is to review some of the legal prob-

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<sup>4</sup> *But see* Lieberman v. Neptune Township, 50 N.J. Super. 192, 141 A.2d 553 (Super. Ct. App. Div. 1958), wherein the court declared a sale of public land illegal on the ground that a requirement for deposit three days prior to date of sale was calculated to reduce the number of possible bidders and not conducive to realization of highest possible price. See also note 2 *supra*.

<sup>5</sup> *Wilmott v. State Purchasing Comm'm*, 246 Ky. 115, 54 S.W.2d 634 (1932); *Albanese v. Machtetto*, 5 N.J. Super. 605, 68 A.2d 659 (Super. Ct. L. Div. 1949); *East River Gaslight Co. v. Donnelly*, 93 N.Y. 557 (1883); *Hibbs v. Arensberg*, 276 Pa. 24, 119 Atl. 727 (1923).

<sup>6</sup> 39 U.S.C. § 426 (1958); Act of Jan. 12, 1895, ch. 23, § 5, 28 Stat. 602, as amended, 44 U.S.C. § 7 (1958).

<sup>7</sup> ASPR 10-102 (Jan. 31, 1961); Federal Procurement Regs. § 1-10.102 (1961).

<sup>8</sup> See text accompanying note 84 *infra*.

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lems stemming from the efforts of administrative agencies to assure, by means of guarantees, that bidders will enter into contracts in accordance with the terms of their offers. These problems fall into two broad categories:

(1) Rights of parties where a bid guarantee has been furnished as required but where the bidder to whom award is to be made desires to withdraw his bid ;and

(2) Rights of parties where a bidder otherwise qualified for award fails to meet requirements for guarantee of his bid.

First, various legal questions concerning the contractual relationship of bidders and public agencies as affected by requirements for bid guarantees will be considered, and, second, the related role of the Comptroller General of the United States will be discussed.<sup>9</sup>

### 11. BID GUARANTEES — THE CONTRACTUAL RELATION

#### A. FAILURE TO FURNISH REQUIRED BID GUARANTEE

The Court of Claims in *Adelhardt Construction Company v. United States*<sup>10</sup> considered the question whether a valid contract resulted where the Federal Government accepted plaintiff's bid and made award to him, notwithstanding his failure to furnish a bid guarantee as required by the Government's invitation for bids and notwithstanding administrative regulations in effect at that time which provided that:

**Where security is required to insure the execution of contract and bond for performance of the service, no bid will be considered unless it is so guaranteed."**

In holding that a valid contract was consummated, the court emphasized that the regulation and requirement for bid guarantee were "obviously intended for the benefit of the Government." Reliance was also placed upon the well-established principle enunciated in *United States v. N. Y. & Porto Rico S. S. Co.*<sup>11</sup> that there are circumstances in which a party for whose protection a requirement is made may waive that requirement. The Supreme Court held in that case that "Even when a statute in so many words declares a transaction void for want of certain forms, the party for whose protection the requirement is made often may waive it, void being held to mean only voidable at the party's choice."<sup>12</sup> Similar reasoning was applied in *Cady v. City of San Bernadino*<sup>14</sup>

<sup>9</sup> The current Comptroller General is the Honorable Joseph Campbell, who was appointed on March 18, 1955.

<sup>10</sup> 123 Ct. Cl. 456, 107 F.Supp. 845 (1952).

<sup>11</sup> As set forth in 123 Ct. Cl. at 459, 107 F.Supp. at 846.

<sup>12</sup> 239 U.S.88 (1915).

<sup>13</sup> *Id.* at 93.

<sup>14</sup> 153 Cal. 24, 94 Pac. 242 (1908).

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and *McCord v. Lauterbach*.<sup>15</sup> It should be noted, however, that in the *Adelhardt* case, the bidder had held its offer open and sought to avoid the contract only after acceptance of its outstanding offer had been made. And the *Cady* and *McCord* cases involved taxpayer suits to void contracts entered into in good faith by bidders who failed to fully meet bid guarantee requirements. The Supreme Court of California in the *Cady* case did recognize, however, that the taxpayer might have had a justiciable grievance to prevent consideration of an otherwise successful bidder's offer, on the ground that the offer was not accompanied by a guarantee in the required amount. But the court added that such grievance was certainly at an end when the contract was entered into.

Thus, it may be concluded that where a public contract has been awarded to an otherwise qualified bidder who has not attempted to withdraw his offer, the validity of the resulting contract may not be impugned on the basis that the successful bidder did not meet the requirements for guarantee of his bid. When a contract is entered into, the purpose of the guarantee requirement is at an end; and it would seem to follow that there is no proper legal basis for attacking a contract on the ground of failure to comply with a non-existent requirement.

But what if the bidder, himself, after all bids have been opened, seeks to withdraw his bid prior to award, on the basis that he has failed to furnish a required bid guarantee?<sup>16</sup> No court case covering this question has been found. However, considering that both the military and civilian procurement regulations preclude withdrawal of bids after the time set for public opening of bids (except in certain specified circumstances not pertinent here),<sup>17</sup> it would seem to follow from the rationale of the above cases, that a bidder could not rely upon his failure to meet a bid guarantee requirement imposed for the Government's benefit to relieve him of his duty to keep his offer open for the time specified in his bid or for a reasonable time if none is specified.<sup>18</sup> On the other hand, it would not appear that an otherwise lowest responsive bidder who failed to meet bid guarantee requirements would have any sound basis for contesting a proposed award to another.<sup>19</sup> It seems safe to

<sup>15</sup> 91 App. Div. 315, 86 N.Y.S. 503 (1904).

<sup>16</sup> Any bidder may, of course, withdraw his bid before bid opening. Federal Procurement Regs. § 1-2.304 (1960); ASPR 2-304 (April 15, 1962).

<sup>17</sup> Federal Procurement Regs. § 1-2.305 (1960); ASPR 2-305 (April 15, 1962).

<sup>18</sup> See note 2 supra.

<sup>19</sup> In *Tony Amode Co. v. Town of Woodward, Inc.*, 192 Iowa 535, 185 N.W. 94 (1921), the bidder was not allowed after acceptance to withdraw his bid and recover his bid deposit on the ground that the insufficiency of the deposit rendered the contract illegal.

conclude that the courts would not interfere where a low bid unaccompanied by required bid guarantee but otherwise responsive is either rejected or accepted.

### B. *BID GUARANTEE FURNISHED*

Of course, where a required bid guarantee is furnished and the bidder submitting it enters into the advertised contract furnishing such contract bonds as are stipulated, the purpose for the bid guarantee is at an end. Bid deposit is then refunded or sureties relieved of all liability. However, Government contracting is not always so free from entanglements ; and it is with respect to those cases where a bidder seeks to renege on his offer that the bid guarantee problems arise.

Inasmuch as the purpose of a bid guarantee is to assure execution of a contract according to the terms of a bidder's offer, failure of the bidder to comply with the terms of his offer should give rise to a basis for forfeiting the bid guarantee furnished. This is true where a bidder's refusal to contract is unjustified in terms of any legal or equitable considerations. In view of the purpose for requiring a deposit or security to accompany a bid, any act or omission of the bidder which, through the lack of ordinary diligence, is not discovered until the time arrives for execution of a contract generally may not be relied upon to preclude forfeiture of the security for refusal to enter into a contract. But, aside from any question of bid guarantee, where there is some basis upon which the bidder should properly be relieved of his obligation to contract, such relief generally carries with it nonforfeiture of any bid guarantee that might be involved.<sup>20</sup>

The most frequent situation giving rise to litigation of the question of bid guarantee forfeiture is where a bidder alleges mistake in the preparation of his bid and, therefore, seeks to withdraw from the obligation of his offer. It is not within the purview of this article to explore all the situations in which a bidder, alleging mistake, may properly withdraw his bid after public opening. It is sufficient for our purposes to point out that where notice of a mistake in bid has been communicated to the Government before its acceptance, and the mistake is remediable in equity, it is also equitable to restore the amount of a deposit required to accompany the bid or to cancel security liability similarly required." And

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<sup>20</sup> See note 2 *supra*; *Lemoge Electric v. County of San Mates*, 46 Cal.2d 659, 297 P.2d 638 (1956); *Brendese v. Schenectady*, 194 Misc. 150, 85 N.Y. S.2d 856 (Sup. Ct. 1947); 17 Comp. Gen. 532 (1937); 17 *id.* 659 (1938).

<sup>21</sup> See *Rushlight Automatic Sprinkler Co. v. City of Portland*, 189 Ore. 194, 219 P.2d 732 (1950), for an exhaustive review of the authorities on mistakes in bids for public contracts.

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it has been held that where the Government gains knowledge of a remediable mistake in bid after acceptance of the bid, but before a contract is executed or the position of the parties has been materially altered, equitable relief by way of restitution, cancellation, or similar remedy may be made available to restore a deposit or eliminate a security liability.<sup>22</sup> The Oregon Supreme Court in *State Highway Comm'n v. State Constr. Co.*,<sup>23</sup> held, citing *Donaldson v. Abraham*<sup>24</sup> and *Kutsche v. Ford*,<sup>25</sup> that :

... The gain to be derived by a forfeiture of the money represented by the bid bond, or by having to accept a higher bid, is not such a loss or injury as forms ground for denying equitable relief.<sup>26</sup>

These general rules were applied even where a bid guarantee was required under statutes providing that the proceeds of the guarantee would become the property of the public body "if the bidder fails or refuses" to execute "the required contract."<sup>27</sup> However, a provision against withdrawal of a bid for a public contract generally has been construed somewhat more strictly against the bidder's right to recovery of his bid guarantee because of a mistake in his bid.<sup>28</sup> In *Mayor and City Council of Baltimore v. J. L. Robinson Constr. Co.*,<sup>29</sup> the statute provided that once a bid was filed it was irrevocable, and required a deposit to indemnify the City in case the bidder, if successful, failed to execute the contract. The Maryland Court of Appeals held that the bidder, who just subsequent to bid opening and after requesting withdrawal of his bid prior to the opening, showed that he had mistakenly understated the amount of a subcontractor's bid included in his bid, forfeited his deposit accordingly.<sup>30</sup> The court stated, however, that the amount of error was not substantial or palpable and suggested that, in the case of a substantial mistake, there would be available the remedy of rescission of the contract, if sufficient cause could be shown for equitable relief on the ground of mistake."

In *M. F. Kemper Const. Co. v. City of Los Angeles*,<sup>32</sup> however, under a bid invitation stating that bidders "will not be released on

<sup>22</sup> Annot., 52 A.L.R.2d 807-09 (1957), and cases cited therein.

<sup>23</sup> 203 Ore. 414, 280 P.2d 370 (1955).

<sup>24</sup> 68 Wash. 208, 122 Pac. 1003 (1912).

<sup>25</sup> 222 Mich. 442, 192 N.W. 714 (1923).

<sup>26</sup> 203 Ore. at 436, 280 P.2d at 381.

<sup>27</sup> *M. F. Kemper Const. Co. v. Los Angeles*, 37 Cal.2d 696, 235 P.2d (1951) (dissent); see also *Moffett, Hodgkins and Clarke Co. v. Rochester*, 178 U.S. 373 (1900).

<sup>28</sup> *Robinson v. Bd. of Educ.*, 98 Ill. App. 100 (1901); 15 Comp. Gen. 1049 (1936); 17 *id.* 669 (1938); 27 *id.* 436 (1948).

<sup>29</sup> 123 Md. 660, 91 Atl. 682 (1914).

<sup>30</sup> See also *Daddario v. Milford*, 296 Mass. 92, 5 N.E.2d 23 (1936).

<sup>31</sup> See Annot., 52 A.L.R.2d 810 (1957), and other cases annotated therein.

<sup>32</sup> 37 Cal.2d 696, 235 P.2d 7 (1951).

account of errors” and where the bidder inadvertently omitted an item in the amount \$301,769 from its bid of \$780,305, the court allowed the bid to be withdrawn without forfeiture of the bid guarantee. The court stated that:

There is a difference between mere mechanical or clerical errors made in tabulating or transcribing figures and errors of judgment, as, for example, underestimating the cost of labor or materials. The distinction between the two types of error is recognized in the cases allowing rescission and in the procedures provided by the state and federal governments for relieving contractors from mistakes in bids on public work. [citations] Generally, relief is refused for error in judgment and allowed only for clerical or mathematical mistakes. [citations] Where a person is denied relief because of an error in judgment, the agreement which is enforced is the one he intended to make, whereas if he is denied relief from a clerical error, he is forced to perform an agreement he had no intention of making.<sup>33</sup>

To summarize, in order for a mistake to be “remediable” within the meaning of the rules set forth above, the following essential conditions must obtain :

1. The mistake is of such consequence that enforcement would be unconscionable ;
2. The mistake relates to the substance of the consideration, that is, a material feature ;
3. The mistake has not occurred through violation of a positive duty in making up a bid, so as to amount to gross or willful negligence ; and
4. It is possible to place the Government in status quo.<sup>34</sup>

Where a mistake in bid has occurred, the bidder alleging the error may be relieved of liability under his bid and the bid guarantee released if all of the four conditions listed above are evident. But in *John J. Bowes Co. v. Town of Milton*,<sup>35</sup> the Supreme Judicial Court of Massachusetts held, where a bidder claimed error after full discussion of his revised bid, that the mistake involved was unilateral within the bidder’s responsibility and the bid guarantee was forfeited.<sup>36</sup>

<sup>33</sup> *Id.* at 703, 235 P.2d at 11-12. See also note 21 *supra*; *People v. City of Buffalo*, 5 Misc. 36, 25 N.Y.S. 50, 53 (Sup. Ct. 1893); and *Puget Sound Painters v. State*, 45 Wash.2d 819, 278 P.2d 302 (1954). *Cf.* *United States v. Conti*, 119 F.2d 652, 656 (1st Cir. 1941), wherein it was held that the fact that the defendant “made an error in his figuring” did not afford him a valid ground for withdrawing his bid. To similar effect, see *John J. Bowes Co. v. Town of Milton*, 255 Mass. 228, 151 N.E. 116 (1926).

<sup>34</sup> *Grymes v. Sanders*, 93 U.S. 55 (1876); *M. F. Kemper Constr. Co. v. Los Angeles*, *supra* note 32; note 21 *supra*.

<sup>35</sup> 255 Mass. 228, 151 N.E. 116 (1926).

<sup>36</sup> *Crilly v. Bd. of Educ.*, 54 Ill. App. 371 (1894); *Gregory Ferend Co. v. State*, 251 App. Div. 13, 295 N.Y.S. 715 (1937); *Brendese v. Schenectady*, *supra* note 20; note 29 *supra*.

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### 111. BID GUARANTEE AS PENALTY OR LIQUIDATED DAMAGES

Frequently, there is litigation relating to the question of whether various contract provisions setting forth in advance stipulated amounts to cover damages for breach are to be regarded as penalties or liquidated damages.<sup>37</sup> It is surprising, in view of the wide difference of judicial opinion in the matter, that so few of such cases concern forfeiture of bid guarantee. With respect to the plaintiff's contention in *Wheaton Bldg. & Lumber Co. v. City of Boston*<sup>38</sup> that his bid deposit was a penalty, and, hence, unenforceable, the court held that the terms of the agreement indicated an intent to treat the deposit as liquidated damage and that this appeared to be the purpose of the statute. The statute required bids to be accompanied by a deposit and the bidder had agreed that his deposit would be the property of the City if he failed to execute a contract within a specified time. The \$2,000 deposit in this case was in fact much smaller than the \$24,000 loss sustained by the City by reason of its having had to award the contract to another bidder.<sup>39</sup> In contrast to the *Wheaton* case, there is the case of *United States v. Conti*<sup>40</sup> wherein the court held that a bid security in the sum of \$200 did not constitute liquidated damages where the Government was required to award the contract to a higher bidder at an excess cost of \$2,344.

In view of the approximate equality, in these two cases, of the ratio of security to damages, it is difficult to reconcile them. Referring to the *Wheaton* case, the court in *John J. Bowes Co. v. Town of Milton*<sup>41</sup> stated that;

The terms of the invitation to contractors to bid show that it was intended to treat the deposit as liquidated damages, and it must be so regarded. The plaintiff is liable only to the extent of its deposit. It follows that it is not liable for damages sustained by the town . . . because the cost of erecting the building was a sum in excess of the plaintiff's bid.<sup>42</sup>

In reaching this conclusion, the court in the *Bowes* case distinguished the preliminary agreement in connection with which the deposit was made, that is, the response to the bid invitation, and the formal contract to erect a building, which was the primary

<sup>37</sup> See generally Annot., 106 A.L.R. 292 (1937), 138 A.L.R. 594 (1942), and other references cited therein.

<sup>38</sup> 204 Mass. 218, 90 N.E. 598 (1910).

<sup>39</sup> See *Abner M. Harper, Inc. v. City of Newburgh*, 159 App. Div. 695, 699, 145 N.Y.S. 59, 63 (1913), wherein the amount of bid deposit was considered, in the course of the court's opinion, as liquidated damages. See also 25 Comp. Gen. 352 (1945), holding bid guarantee as liquidated damages; and 26 Comp. Gen. 775 (1947).

<sup>40</sup> 119 F.2d 652 (1st Cir. 1941).

<sup>41</sup> Note 35 *supra*.

<sup>42</sup> 255 Mass. at 234, 151 N.E. at 118.

interest of the Town. The court stated in this regard that if the plaintiff had signed the formal final contract, the terms of the preliminary contract would have been performed by it, and it would have been entitled to return of the deposit.”

But the court in the *Conti* case construed the *Bowes* decision as resting upon an interpretation and application of the Massachusetts statute regulating the letting of construction contracts, which regulations it held were not applicable to contracts for public works let by the Federal Government. The distinction made was that in the *Bowes* case a written formal contract was required in addition to acceptance of the bidder’s proposal, whereas, in the *Conti* case no formal written contract was required after acceptance. Under these circumstances and where the Government accepted the bidder’s offer before its withdrawal, the court in effect, stated that the bid security was a deposit of “earnest money” which bore no relationship to any damages attributable to failure of contract performance.<sup>44</sup>

The Court of Claims in *Winters v. United States*<sup>45</sup> reasoned, however, as follows :

The Government argues, in effect, that although the plaintiffs were required to furnish this bond, as an express evidence of liability only in the amount of \$1,800 for their breach in not completing the execution of the formal contract, they at the same time, and as a result of the same events, became liable, without limit, for all the damages resulting from the Government’s having the work done outside the contract and at a higher cost. It would be extraordinary for parties to contract for a liability limited to \$1,800 in the event of the occurrence of the exact events which did occur, and at the same time contract for an unlimited liability for the very same events. If the unlimited liability was contracted for, it must have rested either upon general principles of the law of contracts, or upon some other express provision of the contract papers. As to general principles of contracts, we have no doubt that if an owner asked for bids for work and required a bid bond composed by himself and containing the language which this one contained, he would be regarded as being content, at the preliminary stage of the bidding and the execution of the formal contracts, with limited liability stated in the bond.

\* \* \*

It would be entirely reasonable for the Government, or any owner, to be content with a limited liability in the preliminary stages of contract making, sufficient to insure against frivolous bidding, but not large enough

<sup>43</sup> See the dissenting opinion in *M. F. Kemper Const. Co. v. Los Angeles*, note 32 *supra*.

<sup>44</sup> *Cf.* *Bd. of Trustees of Nat’l Training School for Boys v. O. D. Wilson, Inc.*, 133 F.2d 399 (D.C. Cir. 1943); *Bd. of Regents of Murray State Normal School v. Cole*, 290 Ky. 761, 273 S.W. 508 (1925); 38 Comp. Gen. 376 (1958); *U. S. Dep’t of Army, Pamphlet No. 715-50-2, Bonds*, para. 7 (1960) (Procurement Legal Service).

<sup>45</sup> 114 Ct. Cl. 394, 84 F.Supp. 756 (1949).

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to frighten away possible bidders, who, not having large resources of their own, could not be sure of obtaining a surety if their bids should be accepted.<sup>46</sup>

While it is true that the *Winters* and *Conti* cases may be distinguished in that the former contemplated execution of a formal contract, whereas the latter did not, it nevertheless would appear that the *Conti* case rests upon a technical interpretation that bears little relationship to the purpose for which a bid guarantee is required. Indeed, under the court's reasoning in that case, there was virtually no real purpose served by the required bid deposit of \$200 where the ultimate contract involved some \$18,000.

Also of interest and further complicating the issue of legal liability in the case of bid guarantee forfeiture is the case of *Petrovich v. City of Arcadia*.<sup>47</sup> It was held that the bid bond measured the City's compensatory right to the extent of actual damages only, and the liability of the surety was deemed to be established for actual damages resulting from the breach but limited by the sum stated in the bond. This conclusion was reached on the basis of a purported ambiguity in the bid invitation which the court construed strictly against the City. However, an analysis of the facts in the case shows that any ambiguity involved was, in large measure, due to the fault of the bidder. The dissent argued quite forcefully that there was no real basis for construing the bid guarantee as other than a provision for liquidated damages. It seems possible that the real basis for the majority opinion was a reluctance to forfeit a \$37,500 bond in the absence of a proving of actual damages by the City, notwithstanding the fact that an agreement in advance to an amount in liquidation of damages is for the very purpose of avoiding the necessity for actual damages.

Of course, where a bond is furnished as guarantee for a bid, the terms of the bond would govern the extent of liability under the guarantee.<sup>48</sup> And the Comptroller General has held, where a certified check was posted with a bid, in lieu of a required bond to cover the excess cost of the Government in the event of failure to enter into the contemplated contract, that the amount deposited was not in liquidation of damages but that the terms of the required bond were controlling and that the bidder was liable for actual excess costs to the Government.<sup>49</sup>

<sup>46</sup> *Id.* at 407-8, 84 F.Supp. at 759.

<sup>47</sup> 36 Cal.2d 78, 222 P.2d 231 (1950).

<sup>48</sup> For a discussion of surety liability under bonds, see generally Annot., 70 A.L.R.2d 1370 (1960).

<sup>49</sup> 18 Comp. Gen. 54 (1938).

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### IV. THE ROLE OF THE COMPTROLLER GENERAL A. CONTRASTED WITH THE COURTS

The primary function of the Comptroller General, as head of the General Accounting Office under the Budget and Accounting Act, 1921,<sup>50</sup> as amended, is to see that public funds are expended in accordance with the law and for the purposes intended by the Congress. Inherent in the performance of this function is the right and duty to determine the legality of payments made or claimed under Government contracts.<sup>51</sup> As a protection against exception by the Comptroller General to payments made, disbursing officers, certifying officers and the heads of Government agencies may apply to the Comptroller General for a decision on any question involving a payment to be made.<sup>52</sup> And in order to minimize delay in making award of Government contracts, contracting officers or the heads of procuring activities may request an advance decision from the Comptroller General on any question involved in the award of a public contract.<sup>53</sup> In addition to procurement questions raised by Government agencies, there is also that class of cases referred to as "bid protest" cases involving an allegation by an unsuccessful bidder that an award of a Government contract to another bidder is legally questionable. This category of cases is, as stated by the Comptroller General, within the province of the General Accounting Office "in settling accounts and determining the availability of appropriations to see that contracts involving the expenditure of public funds be legally made, including observance of the law respecting competitive bidding."<sup>54</sup>

The procedures being followed by Federal procurement agencies with respect to bid guarantees derive substantially from rulings of the Comptroller General. It should be noted that the interest of the Comptroller General, in cases involving questions relating to contract award, goes beyond considerations involved in litigation. Whereas the courts are primarily concerned with the contractual relationships in which the parties find themselves, the Comptroller General often finds himself concerned, in addition, with matters of Government procurement policy. His decisions concerning bid guarantees, which generally concern whether an award may be

<sup>50</sup> Ch. 18, tit. 111, § 301, 42 Stat. 23, as amended, 31 U.S.C. §§ 41-60 (1958).

<sup>51</sup> Rev. Stat. § 236 (1875), as amended by the Act of June 10, 1921, ch. 18, tit. III, § 305, 42 Stat. 24, 31 U.S.C. § 71 (1958).

<sup>52</sup> Act of July 31, 1894, ch. 174, § 8, 28 Stat. 207, as amended, 31 U.S.C. § 74 (1958); Act of Dec. 29, 1941, ch. 641, § 3, 55 Stat. 876, 31 U.S.C. § 82d (1958).

<sup>53</sup> 36 Comp. Gen. 513 (1957); U. S. Dep't of Army, Pamphlet No. 715-50-2, Bids & Awards, para. 9 (1960) (Procurement Legal Service).

<sup>54</sup> 17 Comp. Gen. 554, 557 (1938).

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made to a bidder who has not fully complied with the bid guarantee requirements of an invitation, constitute a prime example of the role played by the Comptroller General in Federal procurement policy. In tracing the development of Comptroller General decisions relating to bid guarantees, it will be seen that some of them appear to conflict with decisions of the courts. This seeming conflict arises by virtue of the overriding interest and emphasis placed by the Comptroller General on the preservation of an effective competitive bidding system for the letting of contracts by the Government. The Comptroller General has consistently held that the strict maintenance of the competitive bidding system, required by law, is infinitely more in the public interest than obtaining an apparent pecuniary advantage in a particular case by a violation of the rules.<sup>55</sup> Thus, in certain circumstances, although it might be possible to effect an award which would result in a contract that the Federal courts would not disturb, the Comptroller General might well require that the bid be disregarded.<sup>56</sup> The Supreme Court in *Perkins v. Lukens Steel Co.*<sup>57</sup> has stated that the statute requiring the Government's contracts be made after public advertising was not enacted for the protection of sellers and confers no enforceable rights upon prospective bidders.<sup>58</sup> While the Court of Claims, in *Heyer Products Co. v. United States*<sup>59</sup> has held that under the competitive bidding statutes, the Government is obligated to consider honestly all bids and may not arbitrarily and capriciously refuse to award a contract to a bidder whose bid was responsive and most advantageous to the Government, the court did not disturb an award made to a bidder other than the one entitled but indicated only that the injured bidder is entitled to recover provable expenses incurred in preparing his bid.<sup>60</sup> The Comptroller General's concern over proper administration of the competitive bidding statutes has provided bidders for Government contracts the only readily available independent forum wherein their entitle-

<sup>55</sup> *Id.* at 558-59.

<sup>56</sup> See, for example, 39 Comp. Gen. 282 (1959); 38 *id.* 532 (1959); U. S. Dep't of Army, Pamphlet No. 715-50-2, Bonds, para. 8 (1960) (Procurement Legal Service).

<sup>57</sup> 310 U.S. 113 (1940). See also U. S. Dep't of Army, Pamphlet No. 27-151, Cases and Materials on Government Contracts 93 (1961).

<sup>58</sup> See also *American Smelting & Refining Co. v. United States*, 295 U.S. 75 (1922). Accord, *O'Brien v. Carney*, 6 F.Supp. 761 (D. Mass. 1934), U. S. Dep't of Army, Pamphlet No. 27-151, *supra* note 57, at 98. *But cf.* *Copper Plumbing & Heating Co. v. Campbell*, 290 F.2d 368 (D.C. Cir. 1961), U. S. Dep't of Army, Pamphlet No. 715-50-82, § 111, para. 4 (1961) (Procurement Legal Service).

<sup>59</sup> 135 Ct. Cl. 63, 140 F.Supp. 409 (1956), U. S. Dep't of Army, Pamphlet No. 27-151, *supra* note 57, at 101.

<sup>60</sup> See notes 4, 14, and 15 *supra*.

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ment to contract awards can be adjudicated, particularly in view of the position taken by the Federal courts in regard to the rights of rejected bidders.

### B. BID GUARANTEE AS A MINOR INFORMALITY

For many years the Comptroller General viewed the requirement for a bid guarantee as a minor informality which might be waived if it were in the interest of the Government to do so.<sup>61</sup> This view, based on the rationale that the guarantee requirement was for the Government's, rather than the bidder's, benefit, was in line with the decision of the Supreme Court in *United States v. New York & Porto Rico S. S. Co.*,<sup>62</sup> of the Court of Claims in the *Adelhardt Construction Company*<sup>63</sup> case, referred to above, and other cases.<sup>64</sup> In an early decision the Comptroller General authorized acceptance of a bid which was \$261,551 lower than the next low bid but unaccompanied by a required bid guarantee, on the ground that the Government has the right to waive informalities when in the public interest, "and, of course, it is in the public interest to save the sum of \$261,551."<sup>65</sup> It is interesting to note that one of the arguments strongly urged in the case was that failure of the Government to enforce the requirement for bid security was not in accord with the spirit of fair competition in that all bidders were not given equal treatment. Another argument that the failure to enforce the security requirement would make possible the brokering or selling of contracts was disposed of with the conclusion that the legal liability of the bidder to perform or pay damages if his bid were accepted was a sufficient deterrent to the submission of bids by those who might wish to withdraw them after bid opening.<sup>66</sup>

In subsequent decisions these views were amplified and clarified to some extent, but the only substantial exception to the general principle was that, if it appeared that the bidder's failure to furnish the guarantee was due to inability rather than inadvertence, his bid was to be rejected. In 1951, the Comptroller General issued

<sup>61</sup> 7 Comp. Gen. 568 (1928); 16 *id.* 493 (1936); 16 *id.* 809 (1937); 26 *id.* 49 (1946).

<sup>62</sup> 239 U.S. 88 (1915).

<sup>63</sup> 123 Ct. Cl. 456, 107 F.Supp. 845 (1952).

<sup>64</sup> See notes 57 and 58 *supra*; *McGown v. Parish*, 237 U.S. 285, 294 (1915); *Stanley v. Schwalby*, 147 U.S. 508, 514 (1893); *Bailey v. United States*, 109 U.S. 432 (1883).

<sup>65</sup> 14 Comp. Gen. 305 (1934); but see 10 Comp. Gen. 528 (1931), holding that failure to submit a bid guarantee required by statute could not be waived even though the bidder had telegraphed before bid opening that bond had been obtained.

<sup>66</sup> See also 14 Comp. Gen. 559 (1935).

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a decision<sup>67</sup> in which he reviewed the earlier decisions on bid guarantee waivers, in connection with the question as to whether they were equally applicable to procurements under the Armed Services Procurement Act<sup>68</sup> as well as to procurements under the general competitive bidding statute.<sup>69</sup> Notwithstanding the concern expressed by a congressional committee over the frequent waiver of bid guarantee requirements<sup>10</sup> and notwithstanding the continuing efforts of the military services to have the Comptroller General reverse his position, the Comptroller General affirmed the established rule. He pointed out, however, that under the rule, correction of a bid bond deficiency should be permitted only after investigation clearly established that the deficiency did not result from the bidder's inability to obtain a bond, but was due solely to his oversight or other excusable cause." In the particular case submitted, the low bidder had been unable to obtain a bid bond until six days after bid opening, which under the rule as amplified required rejection of the bid and award to the next low bidder. However, because the administrative agency had not timely rejected the bid and since there was a difference of \$148,000 between the low and next low bid, the Comptroller General felt that all bids should be rejected and the procurement readvertised. Here is the first clear cut instance where the Comptroller General, with respect to failure to furnish a required bid guarantee, disregarded the immediate benefit to the Government in favor of the long range benefits of strict compliance with competitive requirements.<sup>72</sup>

### C. BID GUARANTEE AS A MATERIAL REQUIREMENT

A case arose in 1958 involving a bid invitation form which was more emphatically worded than usual with respect to requirements for bid guarantee.<sup>73</sup> The invitation stated that:

Each bidder must submit with its bid a bond. . . . Bid bonds which are not received prior to time of bid opening or contained in an envelope post-marked prior to date and hour of bid opening will not be accepted and the bid will be rejected as non-responsive.

Relying upon the literal terms of this language, the contracting officer rejected a low bid for which the bid bond had not been sub-

<sup>67</sup> 31 Comp. Gen. 20 (1951).

<sup>68</sup> 10 U.S.C. §§ 2301-2314 (1958), as amended.

<sup>69</sup> Rev. Stat. § 3709 (1875), as amended, 41 U.S.C. § 5 (1958).

<sup>70</sup> Staff of Procurement Subcomm., House Comm. on Armed Services, 82d Cong., 1st Sess., Investigation of Bid Bonds (Comm. Print 1951).

<sup>71</sup> See 37 Comp. Gen. 293 (1957), U.S. Dep't of Army, Pamphlet No. 715-50-2, Bids & Awards, para. 46 (1960) (Procurement Legal Service).

<sup>72</sup> See 37 Comp. Gen. 782 (1958); cf. 36 Comp. Gen. 599 (1957), where an award was upheld without going into the question of inability vs. inadvertence.

<sup>73</sup> 38 Comp. Gen. 532 (1959), U.S. Dep't of Army, Pamphlet No. 715-50-2, Bonds, para. 8 (1960) (Procurement Legal Service).

mitted until **28** minutes after the scheduled time for bid opening. The low bidder protested, relying upon the established rule that the late submission of the bond was an informality which should have been waived.

In support of the contracting officer's action the administrative agency pointed out that the net effect of the "waiver rule" urged by the protestant as being applicable :

. . . has been to make it possible for fringe operations to decide, after opening, when the bids of more responsible competitors have been made known, whether or not to attempt to become eligible for award. It was stated that responsible bidders of experience have no fear in submitting their estimates as bids and that surety companies have no reluctance in guaranteeing such bids. The fringe bidder, on the other hand, may have difficulty in obtaining a bid bond unless the surety has some assurance that the amount bid is sufficient to permit the successful execution of the contract. This assurance may come from knowledge made public at the time of bid opening. Thus, if a fringe bidder submits a low bid which is out of line with those submitted by more experienced and responsible bidders, he may be unable to qualify for a bid bond. Even if he nevertheless is awarded the contract and fails to perform, it is likely that he may lack the assets to satisfy a resulting judgment for breach of contract. If, on the other hand, his bid, while low, is in line with other bids, he will, very probably, be able to obtain a bid bond together with some evidence that he could have obtained the bond prior to bid opening.<sup>74</sup>

The Comptroller General on the basis of the foregoing arguments reversed the prior decisions on waiver of bid guarantee requirements. The new rule established by this decision was that where a bid bond is required by the terms of an invitation, the requirement is to be regarded as a material part of the invitation and non-compliance with the requirement would render a bid non-responsive and require its rejection. Three bases were stated in support of the new rule:

1. It is a proper function of administrative agencies to impose upon bidders any reasonable condition relating to eligibility for award;
2. The effect of the old rule allowing waiver of a bid guarantee deficiency compromised the integrity of the competitive bidding system by making it possible for some bidders to choose whether or not they would accept an award ; and
3. The process of weighing evidence to determine whether under the old rule a guarantee deficiency should be waived could result in inconsistent treatment of bidders.

The new rule was intended to recognize a broader scope of administrative discretion in fixing terms and conditions under solicitation and evaluation of bids and to bring the bid guarantee

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<sup>74</sup> *Id.* at 535.

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situation more in line with other decisions dealing with preservation of the competitive bidding system. However, as will be seen from later decisions, it is questionable whether the new rule has accomplished its intended purpose, for, due to the strictness of the new rule, it became necessary to introduce compensating distinctions to allow some flexibility.

With respect to the administrative function of stipulating conditions for bidder eligibility, it is open to argument as to whether an administrative or even a statutory requirement for bid guarantee, which requirement has been consistently held to be for the Government's benefit and therefore subject to waiver, may be made a material matter not subject to waiver irrespective of what the Government interest in a particular case might be. And so far as concerns the compromise of the competitive bidding system through allowing, in effect, an option to the bidder to either furnish the required guarantee after bid opening or to withdraw without doing so, it could be argued that the option is with the Government rather than with the bidder. It is the bidder who must abide by whatever election the Government makes in the matter, since only the Government has the option to waive the bid guarantee or declare such a bidder ineligible for award. And if an award is made, such a non-conforming bidder is legally bound to perform; otherwise, he is liable for such damages as may be incurred as a result of his default.<sup>75</sup> It thus appears that the real basis for the new rule must rest on the practical difficulties experienced in administering the old rule.

### D. EXCEPTIONS TO THE RULE AGAINST WAIVER

An analysis of Comptroller General decisions under the new rule discloses that there has been a gradual introduction of exceptions to this strict rule against waiver of bid guarantee deficiencies. This might be attributable to an inclination to favor, in particular situations, the overriding consideration that the Government's best interests are a material factor in determining the seriousness of the failure to comply with a requirement designed to serve those interests. Also, it is interesting to note that the administrative agencies themselves have by regulation relaxed somewhat the strictness of the new rule which was in large measure adopted at their urging in the first instance.<sup>76</sup>

It has been held, for example, that the failure to extend a bid bond in connection with an extension of the period for bid accept-

<sup>75</sup> 39 Comp. Gen. 796 (1960), U.S. Dep't of Army, Pamphlet No. 715-50-66, § 111, para. 3 (1960) (Procurement Legal Service).

<sup>76</sup> See text accompanying notes 82-86 *infra*.

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ance, an extension requested by the Government, is not within the purview of the new rule requiring rejection of a bid for failure to meet bid guarantee requirements.<sup>77</sup>

The first significant departure from the strictness of the new rule was a decision rendered in response to a question concerning whether the amount of bid security required to be submitted with the bid could be increased after opening to conform to a permitted increase in bid price, where the intention to have submitted a higher bid was supported by clear and convincing evidence. On the basis that the strong showing required to substantiate the *bona fides* of a claim of error would rule out the possibility that a bidder could obtain an undue advantage if adjustment were permitted, the Comptroller General ruled that such adjustment in bid security is permissible after opening, if it was clear that the bidder was able to furnish the bid security in the necessary amount at the time of bid opening.<sup>78</sup> The decision did not make clear wherein the "option" given the bidder in such a situation differs from the "option" given the fringe bidder who generated the new rule.<sup>79</sup>

A further limitation on the application of the new rule was announced in a 1960 Comptroller General opinion,<sup>80</sup> wherein it was ruled that, where a bid deposit was not furnished in the full amount *required* by an invitation covering the sale of surplus property but was sufficient to cover those items on which a split award could have been made, the fact that the invitation was not strictly complied with did not require the rejection of the high bid on such items.

And in a subsequent opinion,<sup>81</sup> it was held that the reasons for adopting the strict new rule had no application in a situation where there was no question but that a proper bid bond had been obtained but was inadvertently left by the bidder prior to bid opening on a Government official's desk to which the bidder did not subsequently have access. Perhaps the strongest reason for adopting the new rule in the first instance was the administrative difficulty of resolving whether in a particular case the failure to submit timely a required bid guarantee was purposeful or inadvertent; yet here the Comptroller General went into the very question of inadvertence.

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<sup>77</sup> 39 Comp. Gen. 122 (1959).

<sup>78</sup> 39 Comp. Gen. 209 (1959), U.S. Dep't of Army, Pamphlet No. 715-50-2, Bids & Awards, para. 94 (1960) (Procurement Legal Service).

<sup>79</sup> See also 39 Comp. Gen. 619 (1960), U.S. Dep't of Army, Pamphlet No. 716-50-64, § 111, para. 4 (1960) (Procurement Legal Service), wherein the bidder was, in effect, given the option of either foregoing the bid or proving delay in the mails.

<sup>80</sup> 39 Comp. Gen. 617 (1960).

<sup>81</sup> 40 Comp. Gen. 469 (1961), U.S. Dep't of Army, Pamphlet No. 715-50-81, § 11, para. 5 (1961) (Procurement Legal Service).

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Also to be considered in connection with the exceptions to the new rule are the regulations promulgated by the Secretary of Defense and the Administrator of General Services.<sup>82</sup> As noted above, these regulations are substantially identical with respect to bid guarantee requirements. But, whereas the new rule establishing the materiality of a bid guarantee requirement in an invitation for bids was established largely at the insistence of administrative agencies, these regulations now vest in the procurement agencies a fairly wide discretion to waive bid guarantee requirements under specified conditions. Prior to these regulations, administrative agencies sought to achieve what is provided by the new rule by phrasing their bid invitations in language that purported to make rejection of a bid for bid guarantee deficiency mandatory. After obtaining the Comptroller General's concurrence with that purpose, however, it is now found that their regulations provide for bid invitations to state that:

Failure to furnish a required bid guarantee in the proper amount by the time set for opening of bid, *may* be cause for rejection of the bid.<sup>83</sup>

The regulations further provide that failure to furnish a required bid guarantee will require rejection of the bid, subject, however, to the following four exceptions:

- (a) Where only a single bid is received. In such cases the Government may or may not require the furnishing of the bid guarantee before award.
- (b) Where the amount of the bid guarantee submitted, though less than the amount required by the invitation for bids, is equal to or greater than the difference between the price stated in the bid and the price stated in the next higher acceptable bid.
- (c) Where the bid guarantee is received late and the late receipt may be waived under the rules established . . . for consideration of late bids.
- (d) Where an otherwise adequate bid guarantee becomes inadequate as a result of the [proper] correction of a mistake in bid . . . if the bidder will increase the amount of the bid guarantee in proportion to the authorized bid correction.<sup>84</sup>

These exceptions apparently derive in part from decisions of the Comptroller General.<sup>85</sup> Also these regulations have been cited with approval by the Comptroller General in several cases.<sup>86</sup>

<sup>82</sup> See note 7 *supra*.

<sup>83</sup> ASPR 10-102(4) (Jan. 31, 1961); Federal Procurement Regs. § 1.10.102(4) (1961).

<sup>84</sup> Federal Procurement Regs. § 1-10.102-5 (1961). See ASPR 10-102.5 (Jan. 31, 1961) for an equivalent set of exceptions.

<sup>85</sup> 39 Comp. Gen. 209 (1959); 39 *id.* 619 (1960); 39 *id.* 796 (1960).

<sup>86</sup> 40 Comp. Gen. 561, 564 (1961). Note, however, that exception (b), *supra*, was relied upon notwithstanding that the invitation provided that "This requirement for bid guarantee will not be waived." 41 Comp. Gen. 74 (1961).

E. CONCLUSION

Thus from a review of the cases, it is apparent that the recent decisions of the Comptroller General are predicated on the basis that the procurement agencies should be allowed to determine whether a bid guarantee requirement shall be a material aspect of a particular procurement. In other words, the requirements set forth in the bid invitation are deemed controlling. But, can it properly be said, concerning the failure to meet a requirement which does not go to the essence of a solicitation and which for many years has been consistently considered an immaterial deviation subject to waiver under most circumstances, that a change in procurement policy can be effected so as to render such deviation material and not subject to waiver? Regardless of how a bid invitation might be worded, the essential relationship of the bid guarantee to the bid is not altered. Nor is the contractual relationship of the bidder and the Government affected. The bid guarantee is separate and distinct from the object of the solicitation; and whether or not the guarantee is furnished, no question is raised regarding the obligations of the successful bidder under the contract awarded or to be awarded. It would appear, therefore, that the decisions of the Comptroller General do not really involve questions of the materiality or non-materiality of bid guarantee deficiencies; but, rather, reflect the philosophy evolved in the Federal courts that the requirement is one for the Government's benefit alone and may, therefore, be waived or not waived at the discretion of the Government. Under this view, the requirements imposed by administrative agencies and interpreted by the Comptroller General constitute the development of a governmental procurement policy rather than determinations based upon positive law. For if the Supreme Court allows waiver of failures to comply with statutory provisions enacted for the benefit of the Government, it would seem that the bid guarantee requirements set forth in administrative regulations are no less subject to waiver.<sup>87</sup>

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<sup>87</sup> See note 10 *supra*.



# THE EMERGENCE OF THE CURRENT INTEREST IN THE DEFENSE SMALL BUSINESS AND LABOR SURPLUS AREA SUBCONTRACTING PROGRAMS\*

BY IRVING MANESS\*\*

## I. INTRODUCTION

The defense small business subcontracting program and the labor surplus area subcontracting program are separate (but not equal) programs. The small business program is authorized by statutory law<sup>1</sup> as well as executive policy. The labor surplus areas program, on the other hand, came into being as a result of Defense Manpower Policy No. 4.<sup>2</sup> For these reasons the two programs will be treated separately in this article.

The two programs are somewhat incompatible since the interests of small business firms outside labor surplus areas may be in conflict with those of large and small firms within such areas. As will be seen later, however, the two programs have reached an accommodation which is perhaps more a marriage of necessity than of convenience.

## II. THE DEFENSE SMALL BUSINESS SUBCONTRACTING PROGRAM

### A. WHAT IS SMALL BUSINESS AND WHY A SMALL BUSINESS POLICY?

The purpose of the Government's small business program, insofar as procurement is concerned, is to insure that a fair proportion

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\*The opinions and conclusions presented herein are those of the author and do not necessarily represent the views of the Small Business Administration, The Judge Advocate General's School, or any other governmental agency.

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<sup>1</sup> Small Business Act, 72 Stat. 384 (1958), 15 U.S.C. §§ 631-647 (1958), as amended, 75 Stat. 666 (1961), 15 U.S.C. §§ 631-647 (Supp. 111, 1962).

<sup>2</sup> Defense Manpower Policy No. 4, Placement of Procurement and Facilities in Areas of Persistent or Substantial Labor Surplus, 18 Fed. Reg. 6995 (1953), as amended by 20 Fed. Reg. 5422 (1955), and as revised by 25 Fed. Reg. 5283 (1960), 32A C.F.R. DMP 4 (Revised) (Supp. 1961). But see the text accompanying note 45, *infra*, for an exposition of the argument that statutory requirements for awarding contracts in procurement by formal advertising need not be complied with in a period of national emergency.

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of the total purchases and contracts or subcontracts for property and services for the Government (including contracts or subcontracts for maintenance, repair, and construction) are placed with small business concerns.<sup>3</sup>

The Small Business Act defines a small business concern as one which is independently owned and operated and which is not dominant in its field of operation.' In addition to these criteria, the Administrator of the Small Business Administration: is authorized, in making a detailed definition, to consider the number of employees and dollar volume of business and to determine within an industry the business enterprises which are to be designated as small business concerns for the purpose of effectuating the provisions of the Act.<sup>6</sup> Pursuant to this authority, the SBA has issued rules and regulations defining small business size standards and special definitions have been issued for certain industries. Generally, however, any concern is small if it does not employ more than **500** persons and meets the statutory requirements.'

The simplest answer to the concern for small business is found in section 2(a) of the Small Business Act itself, which declares that the American economic system of private enterprise is predicated upon full and free competition, the preservation and expansion of which is deemed basic to the economic well-being and security of the nation.<sup>8</sup> This policy did not originate in **1958** with the Small Business Act, but is in the tradition of this country's antitrust and trade practices legislation which is based on the premise that competition produces the best distribution of the nation's economic resources, the greatest progress, and at the same time an environment conducive to the preservation of democratic, political and social institutions.

The United States began its political career as the democracy of small farmers and traders. Its economic development, contrary to that of Europe, began directly with competitive capitalism. It is no coincidence that wherever totalitarianism has gained control, free enterprise has been replaced by cartels, state corporations, or other forms of monopoly.

To illustrate the significance of the small business community to the American economy, approximately **90** percent of the busi-

<sup>3</sup> 75 Stat. 666 (1961), 15 U.S.C. § 631(a) (Supp. 111, 1962).

<sup>4</sup> 72 Stat. 384 (1958), 15 U.S.C. § 632 (1958).

<sup>5</sup> The Small Business Administration will be cited hereinafter as the SBA.

<sup>6</sup> 72 Stat. 389 (1958), 15 U.S.C. § 637(b) (6) (1958).

<sup>7</sup> See 13 C.F.R. §§ 121.3-121.3-11 (Supp. 1961) for the regulations issued by the SBA. The Department of Defense adopted these definitions in formulating their regulations. See Armed Services Procurement Reg. para. 1-701.1 (Feb. 15, 1962) (hereinafter cited as ASPR).

<sup>8</sup> 75 Stat. 666 (1961), 15 U.S.C. § 631(a) (Supp. 111, 1962).

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ness enterprises in this country are classified as small business. This represents about 41½ million firms providing employment to around 40 million people. Of the 324,000 manufacturing concerns in the country today,<sup>9</sup> employing from 16 to 17 million persons,<sup>10</sup> an estimated 310,000, employing from 5 to 5½ million, are small concerns. Among them can be found many competent small firms possessing imagination, ingenuity, and inventiveness. United States Patent Office records reveal that individuals accounted for about 40 percent of all patents issued between 1939 and 1955 and, of the patents issued to American corporations during that period, about 33.4 percent of the total was issued to small and medium concerns and only about 20.8 percent to the 176 largest corporations.<sup>11</sup>

In the light of predictions for the vast economic growth of the nation and with the tremendous expansion of the defense establishment, there is an increasing need for making full use of all the nation's human, technological, and productive resources.

The economics of the national defense requires a strong, healthy, broad-based and dispersed industry in which the millions of small business enterprises scattered throughout the width and breadth of the land must be utilized. A small company can frequently furnish a needed product or service more rapidly and efficiently, of better quality, and at a lower cost than many large concerns which do not ordinarily manufacture these products or provide these services. Size alone does not always bring success, and what the small concern may lack in financial resources, knowledge of market conditions, and research facilities, it may more than compensate for in greater flexibility, closer control and more intensive effort.

### B. GENESIS OF THE CURRENT INTEREST

#### 1. *Legal Basis of the Program*

The present defense small business subcontracting program was established in implementation of the Small Business Act Amendments of 1961.<sup>12</sup> Regulations implementing the program were adopted by the Department of Defense.<sup>13</sup>

<sup>9</sup> U.S. Dep't of Commerce, Survey of Current Business (June, 1961).

<sup>10</sup> U.S. Dep't of Labor, Employment and Earnings 11, Table B1 (March, 1962).

<sup>11</sup> Staff of Subcomm. on Patents, Trademarks, and Copyrights, Senate Comm. on the Judiciary, 84th Cong., 2d Sess., Distribution of Patents to Corporations (1939-1955) 3, 8 (Comm. Print 1957) (Study No. 3).

<sup>12</sup> 75 Stat. 666-669 (1961), 15 U.S.C. §§ 631-647 (Supp. 111, 1962) (hereinafter cited as 1961 Amendments).

<sup>13</sup> ASPR 1-707, 2-407.6 (a) (1), 3-808.2(h) (all dated Feb. 15, 1962) and § 3, Part 9 (dated variously Nov. 15, 1961, and Feb. 15, 1962).

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Prior to enactment of the 1961 Amendments there was almost no legislation on the subject of subcontracting. There was a subcontracting program but it was based upon the provisions of the Armed Services Procurement Regulation. Up to January 1960 the defense small business subcontracting program was on a voluntary basis. In the absence of any statutory requirement, however, the ASPR provisions were ineffective and the program had "little more vitality than an after-the-fact statistical reporting system." On January 1, 1960, by virtue of revised regulations of the Department of Defense, the program became mandatory on all prime contractors and also on all subcontractors who obtained contracts of one million dollars or more with substantial subcontracting possibilities. The new regulations provided some improvement but were still found to be inadequate, and in March 1961 Mr. John E. Horne, Administrator of the SBA, testified before a Senate committee that legislation was needed to provide a basis for a fair and effective subcontracting program."

### *2. The Need for an Effective Subcontracting Program*

Despite the small business set-aside program<sup>16</sup> and all other programs designed to insure that a fair proportion of Government purchasing be placed with small business, climaxed by the request made by President Kennedy in January 1961 that the Secretary of Defense increase the share of procurements for small business by 10 percent, the small business share of military dollar purchases declined each year since 1954 from 25.3 percent to an all time low of 15.9 percent in fiscal year 1961. The percentage for the first eight months of fiscal year 1962 rose to 16.3, however, indicating that these programs may be paying off. The percentages of the total annual military dollar awards of prime contracts that were received by small business concerns are shown on Table I below. To be noted particularly is the diminishing trend of small businesses' share.

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<sup>14</sup> S. Rep. No. 716, 86th Cong., 1st Sess. 5 (1959).

<sup>15</sup> *Hearings on S. 836 Before a Subcommittee of the Senate Committee on Banking and Currency*, 86th Cong., 1st Sess. 68 (1961) (hereinafter cited as 1961 Hearings).

<sup>16</sup> The set-aside program is authorized by § 2(15) of the Small Business Act, 72 Stat. 395 (1958), 15 U.S.C. § 644 (1958), and is implemented in ASPR 1-706 (Nov. 15, 1961). Under this program purchases are set aside in whole or in part exclusively for small business and bidding or negotiation is limited to small business concerns. As a requirement for such a set-aside, there must be a reasonable expectation that bids or proposals will be obtained from a sufficient number of responsible small business concerns so that awards will be made at reasonable prices.

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*Table I*  
(1954-1961)

Fiscal Year	Small Business Percentage of Total Dollar Awards to Business Firms in U.S.
1954	25.3
1955	21.5
1956	19.6
1957	19.8
1958	17.1
1959	16.6
1960	16.1
1961	15.9

SOURCE: Statistical Reports of the Department of Defense.

Research and development contract dollar awards to small firms also dropped from 3.4 percent in fiscal year 1960 to 2.8 percent in fiscal year 1961. Although research and development awards constituted 21.2 percent of the total military dollar purchases in the first six months of fiscal year 1962, small concerns received only 1.9 percent. This is the lowest research and development share for small firms since records have been kept. In fact, there has been a progressive decline in small firms' share of research and development contracts from the high of 5.7 percent in fiscal year 1956.<sup>17</sup>

Annual awards for military construction in the three-year period from 1958 through 1960 also show an alarming decline in the percent awarded to small business. This trend was reversed in fiscal year 1961. In the first six months of fiscal year 1962, however, the percentage awarded to small business fell to an alarmingly low figure. The figures are shown in Table II below.

*Table II*  
*Annual Awards for Military Construction Only*  
(Billions of Dollars)

Fiscal Year	Total Awards	Awards to Small Business	Percent to Small Business
1958	\$1.5	\$1.1	73%
1959	1.4	.9	65%
1960	1.2	.6	50%
1961	1.4	.75	54.1%
1962 (Jul-Dec)	.7882	.2824	35.8%

SOURCE: Statistical Reports of the Department of Defense.

<sup>17</sup> Weekly Staff Report to the Senate Small Business Committee, April 21, 1962.

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Two important developments in military procurement—the weapons-system concept of procurement and the trend toward increased use of procurement by negotiation—may be responsible for the declining trend in the small business share of military purchases. These two developments are directly related since the procurement of major weapons is almost always by negotiation.

Beginning with the Air Force procurement of the B-58 bomber in 1954, the weapons-system concept has become of increasing importance and concern to the Government. Under the weapons system the total responsibility for scheduling, developing, and coordinating all elements necessary to make a new weapon operational—the weapon and its related launch, the test and maintenance of equipment, subsidiary services, site activation, and operational and maintenance training—is concentrated in one prime contractor or, in some cases, in several so-called associate prime contractors. Prior to this time, the major components, such as airframe, navigation system, and communications equipment, were bought from separate sources and were supplied as Government-furnished equipment to be incorporated in the final product by the airframe producer. Concern has been expressed that this concept of procurement has resulted in the concentration of procurement of our major weapons in the hands of fewer and fewer large prime contractors, offering less and less opportunities for small business firms to participate in this important type of procurement.

Statistics compiled by the Department of Defense for fiscal year 1961 show that the net value of military prime contract awards of \$10,000 or more to the 100 companies (including their 118 subsidiary corporations) which receive the largest dollar value of awards amounted to 76.2 percent of the United States total. This compares with 73.4 percent in fiscal year 1960. A comparison of percentages received in the past four years by groups of companies, listed in order of net value of awards, is shown in Table III below. The increase in the procurement of high dollar value items is considered to be the main factor in the high percentage of awards received by the top 100 companies.

*Table III*

Companies	Percent of U.S. Total Dollar Awards			
	FY 1958	FY 1959	FY 1960	FY 1961
1st	9.8%	7.2%	6.0%	8.5%
2nd	6.4	5.2	5.1	5.2
3rd	3.6	4.5	4.8	5.2
4th	3.5	4.1	4.6	4.1

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*Table III—Continued*

Companies	Percent of U.S. Total Dollar Awards			
	FY 1958	FY 1959	FY 1960	FY 1961
5th	3.0	4.0	4.3	3.8
1-5	26.3%	25.0%	24.8%	26.8%
6-10	12.4	12.0	11.3	11.8
11-25	19.1	17.6	17.4	18.2
1-25	57.8%	54.6%	53.5%	56.8%
26-50	9.1	10.7	11.3	11.0
51-75	4.8	5.5	5.4	5.5
76-100	2.5	3.0	3.2	2.9
1-100	74.2%	73.8%	73.4%	76.2%

**SOURCE :** Statistical Reports of the Department of Defense.

Thus, in 1960 Congressman Coffin of Maine stated that “The failure of the contracting agencies to carry out the Congressional small business mandates is aggravated by increasing resort to the weapons system method of procurement. . . . Private contractors who have received large Government contracts are free to ignore Federal small business policies in the letting of subcontracts unless they are required to conform to these policies either by the terms of their prime contracts with the Government or by statutes enacted by the **Congress.**”<sup>18</sup>

In the missile field and in other major areas the prime contract potential of small business firms is recognized as low ; however, such firms can make valuable contributions as subcontractors to weapons system and other prime contractors. This contribution can be achieved only by overcoming the pre-disposition of prime contractors (and their major subcontractors) to produce many components and parts that frequently could be made by small business firms faster, better and at less cost to the Department of Defense.<sup>19</sup>

**SBA** Administrator Horne has stated that the inequities that have developed under the weapons-system concept must be eliminated and that many smaller items and components should be broken out of these large prime contracts. “I am well aware,” he

<sup>18</sup> 106 Cong. Rec. 17719 (1960).

<sup>19</sup> S. Rep. No. 716, *supra* note 14, at 1-2.

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said, "of the tendency to consider that the development and production of weapons systems items are beyond the capacity of small business. I am not convinced of this."<sup>20</sup>

Increased reliance of the Department of Defense on negotiated contracts has made subcontracts of even greater importance to small business.?' Since 1954 when the weapons-system concept began to play a more significant role in military procurement, there has been a steady increase in the dollar volume of negotiated procurements while at the same time the small business share of military procurement has steadily declined. The amounts of procurement by formal advertising and by negotiation and the share going to small business during the period 1954-1961 are shown in Table IV below.

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<sup>20</sup> SBA Press Release No. 865, July 19, 1961. A recent publication of the Department of Defense supports the SBA Administrator's view that small business capability exists in even the most exacting technical areas, including production of components and performance of research and development in connection with weapons systems. US. Dep't of Defense, Small Business Report 5 (April, 1962).

<sup>21</sup> S. Rep. No. 802, 87th Cong., 1st Sess. 3 (1961).

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*Table IV*

SMALL BUSINESS SHARE, ADVERTISED AND NEGOTIATED, OF DEPARTMENT OF DEFENSE PRIME CONTRACT AWARDS WITHIN CONTINENTAL UNITED STATES—FISCAL YEARS 1954-1961  
(Millions of Dollars)

Fiscal Year	1954	1955	1956	1957	1958	1959	1960	1961
<b>ADVERTISED</b>								
Total Awards	\$1,789	2,386	2,815	3,321	3,115	3,089	2,978	2,770
Large Business	638	885	1,065	1,348	1,321	1,623	1,803	1,762
Small Business	1,150	1,501	1,750	1,973	1,794	1,466	1,175	1,008
% to Small Business	64.3	62.9	62.3	59.4	57.6	47.5	39.5	36.4
<b>NEGOTIATED</b>								
Total	\$9,659	12,544	14,935	15,812	18,712	19,655	18,324	20,222
Large Business	8,162	10,653	13,210	14,002	16,777	17,338	16,059	17,573
Small Business	1,752	1,713	1,725	1,810	1,935	2,317	2,265	2,649
% to Small Business	17.7	13.8	11.5	11.4	10.3	11.8	12.4	13.1
<b>TOTAL DOLLAR AWARDS ADVERTISED AND NEGOTIATED</b>								
Total % Advertised	15.6	16.0	15.9	17.4	14.3	13.9	14.0	12.0
Total % Negotiated	84.4	84.0	84.1	82.6	85.7	86.1	86.0	88.0
<b>SMALL BUSINESS % OF TOTAL DOLLAR AWARDS</b>								
	25.3	21.5	19.9	19.8	17.1	15.9	16.1	15.9

SOURCE: Statistical reports of the Department of Defense.

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Several other reasons have been given for the emergence of the current interest in subcontracting." Prime contractors in the larger negotiated procurements, from which small business firms are virtually excluded, enjoy a number of advantages which are denied to the subcontractor. The major prime contractors usually receive cost-plus-a-fixed-fee or price redeterminable type contracts whereas the subcontractor frequently operates under a fixed price contract with less opportune provisions for price adjustment. The prime contractor is often in a better position to obtain advance and progress payments than is his subcontractor. Subcontractors have complained that prime contractors have solicited proposals from subcontractors and have used the technical information submitted in proposals to produce the supplies in their own plants. Pyramiding of fees by weapons system prime contractors has been criticized as resulting in excessive costs to the **Government**.<sup>23</sup> Production by the weapons system contractor of items which he formerly subcontracted results in duplication of facilities. The weapons system prime contractor may find it more profitable to use his responsibility for the end product as an excuse to justify the production in his own plant of items which he formerly subcontracted. Because of the financial benefits involved in receiving a weapon system contract, many of the large contractors may subcontract with each other, further limiting the number of subcontractors.

Largely for these reasons, the Senate Select Committee on Small Business recommended modification of weapons system procurement to allow for direct procurement of subsystems ; safeguarding of potential subcontractors by firmer laws and regulations ; and competitive procurement of components and other parts of the system contract.<sup>24</sup>

### C. LEGISLATIVE HISTORY

Several bills were introduced in the 85th Congress on the subject of subcontracting. **S. 2032**, introduced by Senator Sparkman, provided that a fair proportion of subcontracts as well as contracts should be placed with small business and that subcontracts should be included in the joint determination set-aside program authorized by section 15 of the Small Business Act.<sup>25</sup> **H.R. 12132** and **12212** provided that no contracts awarded pursuant to the set-aside program could be subcontracted except in accordance with rules prescribed by the SBA. These bills failed to pass.

<sup>22</sup> **S. Rep. No. 716**, *supra* note 14, at 19.

<sup>23</sup> **S. Rep. No. 1947**, 86th Cong., 2d Sess. 18 (1960).

<sup>24</sup> **S. Rep. No. 716**, *supra* note 14, at 23.

<sup>25</sup> See note 16 *supra*.

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Another bill, H.R. 11207, introduced in the 86th Congress, passed the House on June 6, 1960, and as amended by the Senate, was approved by that body on July 1, 1960.<sup>26</sup> Section 8 of the bill proposed to add a new subsection to the Small Business Act to require the SBA Administrator, after consultation with General Services Administration and the Department of Defense, to promulgate a small business subcontracting program containing provisions to insure that small business concerns participate equitably as subcontractors under Government contracts; that contractors furnish the SBA information and records concerning subcontracting; and that every contract in excess of \$1,000,000 require the contractor to conform with the program and to insert a similar requirement in all subcontracts in excess of \$500,000. The bill also provided that the program should contain such other requirements as the SBA Administrator may deem necessary.

The Department of Defense and the General Services Administration objected to Section 8 of the bill on the ground that it would assign the sole responsibility for promulgating the program to the SBA and would require a direct relationship between the SBA and Government contractors in violation of the principle that the responsibility of the contracting agency for procurement policy and for supervision of Government contractors is essential to the efficient management of Government procurement.

At the conference held by representatives of both bodies of Congress, the conferees failed to agree and no further action was taken on the bill.

In the 87th Congress, Senator Proxmire introduced S. 836, which contained a provision similar to Section 8 of H.R. 11207 with certain changes designed to meet the objections of the Department of Defense referred to above. The provisions of S. 836 were inserted by amendment in a bill which had been introduced in the House (H.R. 8762) and H.R. 8762, as amended by the Senate, was agreed to in conference and enacted as the Small Business Act Amendments of 1961.<sup>27</sup> These Amendments represent a compromise of the conflicting views as to the authority which the SBA should have over the subcontracting program.<sup>28</sup>

### D. THE NEW SMALL BUSINESS SUBCONTRACTING PROGRAM

The new program, as authorized by the 1961 Amendments, required the three agencies, within 90 days after September 26, 1961,

<sup>26</sup> 106 Cong. Rec. 11926-27 (1960); 106 Cong. Rec. 15430-33 (1960).

<sup>27</sup> 75 Stat. 666-669 (1961), 15 U.S.C. §§ 631-647 (Supp. 111, 1962).

<sup>28</sup> 107 Cong. Rec. 17321-22 (daily ed. Sept. 7, 1961).

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the date of enactment, to develop cooperatively a program to contain such provisions as may be appropriate (1) to enable small business concerns to be considered fairly as subcontractors and suppliers to contractors performing work or rendering services as prime contractors or subcontractors under Government procurement contracts; (2) to insure that such prime contractors and subcontractors will consult through the appropriate procuring agency with the SBA when requested by the administration; and (3) to enable the SBA to obtain from the procuring agency such information and records concerning subcontracting as the SBA may deem necessary.

Thus, the program was to be promulgated not by the SBA, but by the three agencies cooperatively and the SBA was not permitted direct communication with contractors.

The Department of Defense and General Service Administration were to issue implementing regulations with the prior concurrence of the SBA, any disputes to be resolved by the President.

The SBA cannot prescribe the extent to which any contractor or subcontractor shall subcontract, cannot specify the business concerns to which subcontracts shall be granted, and does not have any authority over the administration of individual prime contracts or subcontracts.

On December 7, 1961, the three agencies agreed upon the program. On February 15, 1962, the Department of Defense<sup>29</sup> and on February 26, 1962, the General Services Administration,<sup>30</sup> issued similar implementing regulations.

The regulations require Government prime contractors to assume an affirmative obligation with respect to subcontracting with small business concerns. In contracts from \$5,000 to \$500,000 the contractor is required to accomplish the maximum amount of small business subcontracting consistent with the efficient performance of the contract. In contracts over \$500,000, the contractor must undertake a number of specific responsibilities designed to assure that small business concerns are considered fairly in the subcontracting role and to impose similar responsibilities on major subcontractors. These responsibilities are set forth in a "Small Business Subcontracting Program" clause" required to be included in all contracts which may exceed \$500,000,<sup>32</sup> which con-

<sup>29</sup> See note 13 *supra*.

<sup>30</sup> Federal Procurement Regs. §§ 1-1.710, 1-2.407-6, and 1-3.102(n); subpt. 1-3.9, 27 Fed. Reg. 623-626 (1962).

<sup>31</sup> ASPR 1-707.3 (Feb. 15, 1962).

<sup>32</sup> Although the 1961 Amendments authorize the program in contracts over \$1,000,000 and subcontracts over \$500,000, the three agencies agreed that prime contracts over \$500,000 should also be included in the program.

## SMALL BUSINESS AND LABOR SURPLUS

tain a "Utilization of Small Business Concerns" clause,<sup>33</sup> and which, in the opinion of the purchasing agency, offer substantial subcontracting possibilities.

Under the Small Business Subcontracting Program clause the contractor agrees (1) to establish and conduct a small business subcontracting program which will enable small business concerns to be considered fairly as subcontractors and suppliers; (2) to designate a liaison officer to supervise and administer the contractor's subcontracting program; (3) to consider the potentialities of small business concerns in all "make-or-buy" decisions;<sup>34</sup> (4) to assure that small business concerns will have an equitable opportunity to compete for subcontracts, and, where the contractor's lists of potential small business subcontractors are excessively long, to make a reasonable effort to give all such small business concerns an opportunity to compete over a period of time; (5) to maintain certain subcontracting records;<sup>35</sup> (6) to notify the contracting officer in the event that no small business concerns are to be solicited on any subcontracts over \$10,000 if the contracting officer's consent to subcontracts is required under the contract, and to submit the reasons for such non-solicitation (This requirement is for the purpose of allowing the SBA the opportunity to suggest potential small business sources for consideration by the prime contractor); (7) that in the event of breach of these contractual obligations the contract may be terminated, in whole or in part, for default; and (8) to include in any subcontract in excess of \$500,000 provisions substantially similar to those of this clause.

A Small Business Subcontracting Program clause had also been required under the former program. The old clause was required only in contracts over \$1,000,000. The new clause differs also in that it contains the following provisions which were not present in the earlier clause :

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<sup>33</sup> This clause is to be included in all contracts over \$5,000 except those which are to be performed outside the United States, its possessions, and Puerto Rico, and those for personal services.

<sup>34</sup> A "make-or-buy" program is that part of a contractor's written plan for the development or production of an end item which outlines the major parts to be manufactured in his own facilities and those which will be obtained elsewhere by subcontract. A "make" item is any item produced or work performed by the contractor or his affiliate, subsidiary or division. The "make-or-buy" decision, therefore, is the decision as to whether to make the item or obtain it elsewhere by subcontract. See ASPR 3-902 (dated variously Aug. 21, 1961, Nov. 15, 1961, and Feb. 15, 1962).

<sup>35</sup> Reports on DD Form 1140 are to be submitted semiannually to the Department of Defense by all contractors who maintain defense subcontracting small business programs. The report calls for the amount of military subcontract payments, broken-down as to small and large concerns, and the percentage of the contractor's total receipts from military contracts paid to small business.

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a. The agreement that small business concerns be given an equitable opportunity to compete for subcontracts.

b. The requirement that in the case of excessively long lists of potential subcontractors an effort will be made to give all small concerns an opportunity to compete over a period of time.

c. The maintenance of records and the notification provisions described in points (5) and (6) above.

d. The right to terminate the contract in the event of breach of the contractual obligations under the program.

At the same time as the regulations were being revised to implement the new Small Business Subcontracting Program clause described above, they were also amended with regard to the contractor's "make-or-buy" program. The new regulations, with respect to this program, require submission of the contractor's "make-or-buy" program, in certain cases of negotiated procurements **only**,<sup>36</sup> to the SBA for review and recommendations. The review by the SBA is to be accomplished concurrently with the contracting officer's review of the **program**.<sup>37</sup>

This, then, is the essence of the new small business subcontracting program. It has not been in operation long enough to permit evaluation. If, after all the sound and fury in its enactment into law, and after the fanfare attending its birth, the program appears only slightly less puny than its predecessor, it must be remembered that the proponents of the 1961 Amendments in the Congress considered them to be a compromise to meet the objections of the purchasing agencies.

The burden is upon those agencies and upon the SBA, who concurred in and cooperatively developed the new program, to produce results. If the program does not secure what the Congress considers to be a fair share of subcontracts for small business, it seems certain that efforts will be renewed in the Congress to revive the more drastic methods previously considered, such as direct contact between the SBA and contractors and a joint determination set-aside program for subcontracts.

### 111. THE DEFENSE LABOR SURPLUS AREA SUBCONTRACTING PROGRAM

#### A. *THE BACKGROUND*

The labor surplus area program, and the regulations in implementation thereof, are designed to carry out the executive policy

<sup>36</sup> See ASPR 3-902.1(b) (2) (Nov. 15, 1961) for an exact description of the cases in which this submission is required.

<sup>37</sup> See ASPR 3-902.1(f) (Feb. 15, 1962).

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of the Government of encouraging the placing of contracts in labor surplus areas. Moreover, the program is designed to encourage prime contractors to award subcontracts to firms which will perform a substantial portion of their production on these subcontracts in such labor surplus areas, consistent with efficient performance and with other policies of the Government, at prices no higher than are obtainable elsewhere. This policy has been laid down by the Office of Emergency Planning and its predecessor agencies (Office of Civil and Defense Mobilization, Office of Defense Mobilization, and National Production Authority), and is implemented in the Armed Services Procurement **Regulation**.<sup>38</sup>

The interest in assisting areas of labor surplus seems to have originated in 1950 during the Korean **Emergency**.<sup>39</sup> Requests for help in obtaining defense contracts to alleviate serious unemployment and to utilize existing facilities and skills were received by the National Production Authority and other Government agencies and by members of the Congress. These requests came from individual companies, unions, chambers of commerce and other organizations. In the summer of 1951 the Government stressed the need for defense production and the distressed areas could not understand why their manpower, facilities and skills were not being utilized.

The history of the labor surplus problem is one of struggle to put the policy into effect in the absence of a firm legislative foundation. Not only was there no specific statute authorizing preferences for distressed areas, but the Armed Services Procurement Act of 1947 provided that awards were to be made to the bidder whose bid would be most advantageous to the Government.<sup>40</sup> Moreover, provisions of the Defense Appropriation Act of 1962,<sup>41</sup> and earlier versions of the defense appropriation acts,<sup>42</sup> which prohibit the payment of price differentials on contracts made for the purpose of relieving economic dislocations, actually cast doubt on the legality of the program. The Department of Defense took the

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<sup>38</sup> Defense Manpower Policy No. 4, *supra* note 2 (hereinafter cited as DMP 4). See also ASPR 1-805.1 (April 15, 1962).

<sup>39</sup> Office of Labor, Nat'l Production Authority, Defense Manpower Policy No. 4 and the Surplus Manpower Committee, A History (1953).

<sup>40</sup> 10 U.S.C. § 2306(c) (1958).

<sup>41</sup> Section 623 of Title VI, Department of Defense Appropriation Act, 1962, 76 Stat. 365 (1961).

<sup>42</sup> This restriction was first included in the Department of Defense Appropriation Act, 1954, 67 Stat. 357 (1953), and has been renewed in each subsequent defense appropriation act. The more recent acts also restrict the use of appropriated funds to contracts awarded "on a formally advertised competitive bid basis to the lowest responsible bidder," insofar as practicable. See § 623, Title VI, Department of Defense Appropriation Act, 1962, 75 Stat. 365 (1961).

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position that there was no statutory authority permitting awards of contracts based on the need to utilize manpower skills and facilities without regard to price considerations.<sup>43</sup> The word “advantageous” in the Armed Services Procurement Act of 1947 was interpreted as meaning the lowest price.<sup>44</sup> The National Production Authority, on the other hand, argued that the statutory requirements for awarding contracts in procurement by formal advertising need not be complied with in a period of national emergency<sup>45</sup> (President Truman had declared a national emergency on December 16, 1950)<sup>46</sup> and that multiple awards to different producers rather than to the low bidder, despite the fact that this might result in a somewhat higher unit cost, could also be justified under such emergency legislation as the Defense Production Act of 1950, as amended,<sup>47</sup> and the First War Powers Act of 1941, as amended.<sup>48</sup> On January 17, 1951, President Truman established a National Manpower Mobilization Policy which provided, in part, that “Production will be scheduled, materials allocated, and procurement distributed with careful consideration of available manpower. Whenever feasible from the economic and security standpoint, production facilities, contracts, and significant subcontracts will be located at the sources of labor supply in preference to moving the labor supply.”<sup>49</sup>

Because of the legal objections raised by the Department of Defense, the National Production Authority referred the question to the Comptroller General, who, on January 14, 1952, rendered an opinion stating that there was no objection to making payments on contracts placed in labor surplus areas even though lower prices could be obtained elsewhere.<sup>50</sup>

<sup>43</sup> Office of Labor, Nat'l Production Authority, *op. cit. supra* note 39.

<sup>44</sup> *Zbid.*

<sup>45</sup> *Ibid.*

<sup>46</sup> Proc. No. 2914 (Dec. 16, 1950), 15 Fed. Reg. 9029 (1950), 64 Stat. A454 (1950), 50 U.S.C. App. (notes preceding § 1) (1958).

<sup>47</sup> “Defense Production Act of 1950, ch. 932, 64 Stat. 798, as amended, 50 U.S.C. App. §§ 2061-2166 (1958).

<sup>48</sup> First War Powers Act, ch. 593, 55 Stat. 838 (1941), as amended.

<sup>49</sup> Office of Defense Mobilization, Manpower for Defense—Policies and Statements 5 (1953).

<sup>50</sup> 31 Comp. Gen. 279 (1952). This decision was based on a provision in Section 2(c) (1) of the Armed Services Procurement Act of 1947 authorizing the negotiation of contracts without advertising when determined to be necessary in the public interest during a period of national emergency. The Comptroller General had previously held that in advertised procurements awards to other than the low bidder could not properly be made solely on the basis of small business status or labor surplus area location. 28 Comp. Gen. 662 (1949). Following the decision in 31 Comp. Gen. 279, *supra*, the practice of making premium price awards to labor surplus area firms became the subject of controversy in Congress which resulted in the enactment

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With this legal support, the Director of the Office of Defense Mobilization on February 7, 1952, issued DMP 4, which stated that "The aim of the mobilization program is to develop and maintain the necessary military and economic strength to carry out the policy of the United States to oppose acts of aggression and promote peace. . . . The purpose of this DMP 4 is to provide for procurement by negotiated contracts with responsible concerns which are in an area of . . . labor surplus . . . in cases where the public interest dictates the need for doing so."<sup>51</sup> Although the original DMP 4 did not specifically so provide, its language was broad enough to support an argument for the negotiation of contracts to utilize available manpower, facilities, and skills even though lower prices could be obtained elsewhere.<sup>52</sup>

### B. CURRENT INTEREST

The problems of surplus labor continued after termination of the Korean emergency and continue to this day. With the ending of hostilities the justification for a labor surplus area program in the course of time shifted from national security to economic considerations. The issue was discussed in the Presidential campaign of 1960 in an informal address near Detroit, on October 26, 1960, by John F. Kennedy, the Democratic candidate. He made reference to DMP 4 and said that, if elected, he would take steps to make it work. On February 2, 1961, shortly after his inauguration as President, he directed Government purchasing agencies to recommend improved means to channel contracts to areas of surplus labor and asked that a particularly high priority be given to projects located in such areas. In response to this directive, the SBA immediately amended its size standards regulation, by providing a 25 percent increase in the size standards for small business concerns agreeing to perform a contract in substantial part in areas of labor surplus.<sup>53</sup> The intended effect of this action was to

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in Section 644 of the Department of Defense Appropriation Act, 1954, 67 Stat. 357 (1953), of the prohibition against payment of price differentials to relieve economic distress. This section is identical to that appearing as Section 623 of the 1962 DOD Appropriation Act. See notes 41 and 42 *supra* and accompanying text.

<sup>51</sup> DMP 4, 17 Fed. Reg. 1195 (1952). See note 2 *supra* for citation of subsequent revisions and amendments.

<sup>52</sup> The statutory restriction regarding price differentials (notes 41 and 42 *supra*) is now incorporated in DMP 4. See 32A C.F.R. DMP 4 (Revised) (Supp. 1961), para. 4(b)(1). DMP 4 also established a Surplus Manpower Commission and provided for certification to the Commission by the Secretary of Labor of the existence of labor surplus areas under standards to be established by the Secretary.

<sup>53</sup> 26 Fed. Reg. 1441 (1961), as revised by 26 Fed. Reg. 2778 (1961). See ASPR 1-701.1(a)(3) (April 15, 1962), and Fed. Procurement Regs. § 1-1.701-1(a)(3) (Sept. 1961), for similar amendments to these regulations.

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increase the number of concerns to whom the SBA could give assistance under Government procurement programs and thereby increase the use of labor in labor surplus areas. Because the 25 percent differential applicable to Government procurement and sales failed to increase business in labor surplus areas to any substantial extent, the SBA recently took action to rescind the differential and adopt a new program which it considered would be more productive of results. The small business size standards regulation is being amended to accomplish this. The substitute program developed by the SBA is still under consideration and therefore cannot be discussed in this article. On February 25, 1961, the Department of Defense asked the Comptroller General whether, in view of the President's directive, total set-asides on suitable procurements for award exclusively to firms in labor surplus areas could legally be made. The Comptroller General ruled that the prohibition contained in Section 523 of the Defense Appropriation Act of 1961<sup>54</sup> against payment of price differentials on contracts made for the purpose of relieving economic dislocation barred the use of total set-asides for the purpose of awarding contracts to firms in such areas, and that contracts could not be awarded to a labor surplus area firm at a price in excess of the lowest available.<sup>55</sup>

At the request of the President, the Assistant Secretary of Defense (Installation and Logistics) on June 15, 1961, established the Defense Procurement Assistance Group.<sup>56</sup> Its function was to screen purchase requests exceeding \$500,000 for possible placement in persistent or substantial labor surplus areas. By arrangement with the SBA the Group was furnished the names of small business firms in labor surplus areas which were willing and able to supply the purchase requirements. In January 1962, the Group was abolished and an Economic Utilization Program was estab-

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<sup>54</sup> 74 Stat. 353 (1960).

<sup>55</sup> 40 Comp. Gen. 489 (1961). The bar on total set-asides for labor surplus area firms, however, does not prevent a procuring agency from awarding a contract, on a request for proposals distributed to all prospective offerors regardless of their size or status as labor surplus area concerns, on the following basis: to the low offeror on condition that he agrees to perform more than 50 per cent of the contract in a labor surplus area; if he does not so agree, other firms submitting prices within 120 per cent of the low offer are given an opportunity to meet the low offer in the following order of priority, beginning with the lowest responsive offeror in each category: (1) small business firms which are labor surplus area firms, and (2) large business firms which are labor surplus area firms. If no one agrees to meet the lowest offer, the award is made to the low offeror irrespective of his labor classification. See Ms. Comp. Gen. B-148512 (June 1, 1962).

<sup>56</sup> Office of Sec'y of Defense, Memorandum on Defense Procurement Assistance Group (June 15, 1961).

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ished.<sup>57</sup> The functions of the Defense Procurement Assistance Group were transferred to the newly created position of Director, Economic Utilization Policy, and special assistants to the Director were appointed in each of the three military departments and the newly created Defense Supply Agency.

### C. THE LABOR SURPLUS AREA SUBCONTRACTING PROGRAM

The subcontracting program is considered to be perhaps the most important tool in furnishing procurement assistance to labor surplus areas. As was pointed out, the program is implemented by the Armed Services Procurement **Regulation**.<sup>58</sup> Government prime contractors are required to assume an affirmative obligation to subcontract with labor surplus area concerns. In contracts which range from \$5,000 to \$500,000 the contractor must use his best efforts to place his subcontracts with concerns which will perform them substantially in areas of persistent or substantial labor surplus at prices no higher than obtainable elsewhere. This undertaking is set forth in a contract clause entitled "Utilization of Concerns in Labor Surplus Areas."<sup>59</sup>

In contracts over \$500,000 which contain the "Utilization" clause and which in the opinion of the purchasing agency offer substantial subcontracting possibilities, a "Labor Surplus Area Subcontracting Program" **clause**<sup>60</sup> is required. This program was formerly combined with the small business subcontracting program and a clause entitled "Defense Subcontracting Small Business and Labor Surplus Area **Program**"<sup>61</sup> was used. Since the small business subcontracting program is now authorized by statute, the three agencies concerned—the SBA, the Department of Defense, and the General Services Administration—agreed to divorce the two programs and to restate the labor surplus subcontracting program elsewhere in the Armed Services Procurement Regulation and the Federal Procurement Regulation.

Under the new "Labor Surplus Area Subcontracting Program" clause<sup>62</sup> a prime contractor is required to establish and conduct a program which will encourage labor surplus area concerns to compete for subcontracts within their capabilities. As means to

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<sup>57</sup> Office of Sec'y of Defense, Memorandum on Economic Utilization Policy (Jan. 8, 1962).

<sup>58</sup> See note 38 *supra*. DMP 4 required all procurement agencies to encourage prime contractors to award subcontracts to firms performing a substantial portion of the work in labor surplus areas.

<sup>59</sup> ASPR 1-805.3 (a) (April 16, 1962).

<sup>60</sup> ASPR 1-806.3(b) (April 16, 1962).

<sup>61</sup> ASPR 7-104.22 (Aug. 21, 1961).

<sup>62</sup> ASPR 1-805.3 (b) (April 15, 1962).

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accomplish this end the contractor agrees to designate a liaison officer on labor surplus area matters; to provide adequate and timely consideration of the potentialities of labor surplus area concerns in all "make-or-buy" decisions;<sup>63</sup> to assure that labor surplus area concerns will have an equitable opportunity to compete for the subcontracts; to maintain appropriate records; and to insert similar provisions in subcontracts over **\$500,000** which contain the "Utilization" clause.

### IV. RELATIONSHIP ON THE TWO PROGRAMS

From the very beginning of the surplus labor area program conflicts developed between that program and the small business program. A memorandum of April 22, 1952, in the files of the Office of Defense Mobilization, referred to the necessity for agreement on the priority between distressed areas and small business, and expressed concern that a joint determination operation (the small business set-aside program) might be upset if large concerns within distressed areas received priority over small concerns outside such areas since this might give contracting officials an excuse for not making set-asides.<sup>64</sup> Contracting officers were at a loss as to how to resolve this conflict.

No concrete solution to this problem has been reached, except that the following order of priorities was established for making an award of a labor surplus area set-aside: (1) persistent labor surplus area concerns which are also small business concerns; (2) other persistent labor surplus area concerns; (3) substantial labor surplus area concerns which are also small business concerns; (4) other substantial labor surplus area concerns; and (5) small business concerns which are not labor surplus area concerns.

This order of priority, however, applies only to negotiations for the set-aside portion of procurements<sup>65</sup> and to awards in the case of equal low bids.<sup>66</sup> No priority has been established for the award of contracts or subcontracts in other situations. Furthermore, the order of priority is subject to the criticism that it is too inflexible and does not permit consideration of questions of degree in respect to competency, price, and size, as between competing companies.

<sup>63</sup> See note 34 *supra*.

<sup>64</sup> A memorandum of May 15, 1952, in the SBA's files describes "another case involving a conflict between the distressed area and small business policies." In a negotiated procurement the low bidder was a small concern and the next two were large concerns in distressed areas. The contract was awarded to one of the large concerns on condition that it meet the low bid.

<sup>65</sup> ASPR 1-804.2 (Nov. 15, 1961).

<sup>66</sup> ASPR 2-407.6 (Feb. 15, 1962).

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For these reasons the order of priority policy is at the present time undergoing re-examination.

There are certain dissimilarities between the two programs. For example, the Small Business Act authorizes the SBA to issue certificates of competency for small business **firms**;<sup>67</sup> there is no comparable authority under the labor surplus area program.

Although the preferential actions authorized by DMP 4 do not apply to advertised procurements (except the preference for labor surplus area firms in the event of tie bids), there is a way of placing contracts in labor surplus areas for items normally procured through advertising. This is the set-aside device under which the contracting officer advertises for competitive bids for a portion of the total requirements, the balance being withheld for negotiation with firms in labor surplus areas. No price differential, however, is permissible. The set-aside portion is awarded at the highest unit price awarded on the non-set-aside portion, adjusted to reflect transportation and other costs which were considered in evaluating bids on the non-set-aside **portion**.<sup>68</sup>

Even in the set-aside program, however, there is an inequality between the two policies. In the small business program, total as well as partial set-asides may be made, whereas the prohibition in the Defense Appropriation Acts against payment of price differentials on contracts made for the purpose of relieving economic dislocation, bars the use of total set-asides in the labor surplus area **program**.<sup>69</sup> The real advantage of the total set-aside is (1) price competition is limited to concerns in the qualifying category, and (2) larger quantities, *i.e.*, the total procurement, are awarded to concerns in the qualifying category.

Although the two policies appear to be incompatible, effective assistance to the labor surplus area program can and has come through the SBA. The experienced cadre of small business specialists in the SBA and in the military departments is able to furnish small business sources of supply for the Government's purchase requirements, both within and without labor surplus areas. Through constant effort of this cadre the philosophy behind the small business policy has, to a large extent, been accepted by procurement officials. The small business organization, which has been so effective in promoting the cause of small business, has often been called upon to furnish small business sources in such areas and has always responded to requests for assistance.

<sup>67</sup> 72 Stat. 389 (1958), as amended, 75 Stat. 667, 668 (1961), 15 U.S.C. § 637(b)(7) (Supp. 111, 1962). A certificate of competency is a certification by the SBA to Government contracting officers that a small business concern has the capacity and credit to perform a specific contract.

<sup>68</sup> ASPR 1-804.2(b) (Nov. 15, 1961).

<sup>69</sup> 40 Comp. Gen. 489 (1961).

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Thus, out of practical necessity the labor surplus program has to an extent been wedded to that of small business. The challenge to small business and economic utilization officials is to make the marriage produce beneficial results for both programs, since these two programs, promoting as they do the preservation and expansion of competition in our American economic system and the efficient utilization of manpower, facilities, and skills are based upon permanent and vital policies of the Government.

# THE NEW DEFENSE PROGRAMMING CONCEPT \*

BY LAWRENCE E. CHERMAK\*\*

## I. INTRODUCTION

“The timely translation of economic strength into military power, the proportion of that strength so translated, and the efficiency of the forces in being, have become of critical importance—as opposed to some theoretical maximum potential which could be translated into military force at some later date.” This tying of military plans together with monies and resources reasonably available is the end sought by defense programming. The plans of the military, which reflect their current and future objectives and requirements, are integrated with the current budget effort, as well as with the tentative budget projections, over a five-year period.

Weapon systems, which take almost a decade to evolve, are simultaneously considered in planning and budgeting schemes. At the same time these systems are made compatible with the ever-changing national security policy objectives and national economy considerations. The official expression of all of these objectives and considerations may be found at any time in the “Five Year Force Structure and Financial Program” of the Department of Defense. This document, in book form, includes all of the program elements and reflects the most recently approved changes to the program elements which have been accepted by the Secretary of Defense<sup>2</sup> and the Secretary of the particular military department.

## 11. THE NEW “PROGRAM”

The word “program” is employed by the various components of the Department of Defense with different connotations. For

\* The opinions and conclusions presented herein are those of the author and do not necessarily represent the views of the Department of the Navy, The Judge Advocate General’s School, or any other governmental agency.

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<sup>1</sup> Hitch and McKean, *The Economics of Defense in the Nuclear Age* 8 (1960).

<sup>2</sup> Dep’t of Defense Directive No. 7045.1 (April 12, 1962) (Program Change Control System). The “Five Year Force Structure and Financial Program” is generally known as the DOD Program Book.

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example, the "Five Year Force Structure and Financial Program" consists of nine major military programs ; the first seven of these are reflected, in part, in the proposed 1963 Department of Defense Appropriation Act.<sup>3</sup> These major military programs are :

1. Strategic Retaliatory Forces
2. Continental Air and Missile Defense Forces
3. General Purposes Forces
4. Airlift/Sealift Forces
5. Reserve and Guard Forces
6. Research and Development
7. General Support
8. Civil Defense
9. Military Assistance

These major military programs, in turn, are broken down into elements which are known as program elements. In addition, the military departments have previously established programs within the budget structure programs which were in existence long before defense programming came into being. As a result, a program currently being executed in a military department is a segment of the budget structure rather than a segment of one of the major military programs contained in the defense programming scheme evolved by the Secretary of Defense and the Comptroller of the Defense Department. This dichotomy of programs makes it necessary to review the manner in which the military departments previously controlled the use of the authority granted to them by the Congress before discussing the effect of the new programming procedures being put into effect in the Department of Defense.

### A. CONGRESSIONAL CONTROL

Prior to World War II, Congress controlled the Executive Branch by the simple device of authorizing legislation and appropriations so as to narrowly confine the area of discretion in the Executive Branch.<sup>4</sup> As the functions of the Federal Government expanded, authorizing legislation and appropriations became less confining and particularized. The broadest type of legislative authorization: and appropriations were utilized in supporting the World War II effort.

<sup>3</sup> H.R. 11289, 87th Cong., 2d Sess. (1962). See H.R. Rep. No. 1607, 87th Cong., 2d Sess. (1962). See also *Hearings Before the Subcommittee of the House Committee on Appropriations*, 87th Cong., 2d Sess., pt. 2 (1962).

<sup>4</sup> See Appropriation Acts enacted prior to July 1, 1941, e.g., Military Appropriation Act, 1941, ch. 343, 54 Stat. 350 (1940).

<sup>5</sup> First War Powers Act, 1941, ch. 593, § 1,55 Stat. 838 (1941).

## NEW DEFENSE PROGRAMMING CONCEPT

After World War II, it became apparent that the Executive Branch of the Government could not continue to operate effectively, efficiently and economically by narrowly confining appropriations and utilizing statutory definitions as was the practice prior to World War II. Accordingly, Congress passed statutes which recognized the need for performance budgeting<sup>6</sup> in lieu of the narrow object classification previously followed as the basis for appropriation structure. With the introduction of performance budgeting, the appropriation structure became extremely broad in purpose and specific congressional control began to disappear.

### B. APPROPRIATIONS COMMITTEES

This lack of appropriation control became very apparent to the Department of Defense Subcommittee of the House Committee on Appropriations. Accordingly, the House Appropriations Committee and the Senate Appropriations Committee<sup>7</sup> directed that the Department of Defense adhere, with certain accepted variances, to the programs justified in the Budget. It was intended that the responsible officials of the department "keep faith with the Committee and the Congress by respecting the integrity of justifications presented in support of the budget requests."<sup>8</sup> If any changes were to be made in the budget program, then a reprogramming action would have to be taken, and Congress would have to be provided with information concerning any significant variations from the justification. This requirement had the effect of establishing, within a broad appropriation, certain limitations. These limitations were not legal in effect but were in the nature of arrangements with Congress regarding the discretion that the Department of Defense would exercise in the execution of budget programs. This requirement was reported by the Eighty-Sixth Congress.<sup>9</sup>

### C. ARMED SERVICES COMMITTEES

In 1959 the Armed Services Committees began to recognize that the reprogramming arrangements of the Appropriations Committees were, in effect, establishing and defining the programs themselves. Up to that time, the Armed Services Committees had sponsored all of the substantive legislation which

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<sup>6</sup> National Security Act Amendments of 1949, ch. 412, § 11, 63 Stat. 585, 5 U.S.C. § 172b (1958).

<sup>7</sup> H.R. Rep. No. 493, 84th Cong., 1st Sess. 8 (1955).

<sup>8</sup> *Ibid.*

<sup>9</sup> H.R. Rep. No. 408, 86th Cong., 1st Sess. 20 (1959); S. Rep. No. 476, 86th Cong., 1st Sess. 27 (1959).

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defined the powers which were to be exercised by the military departments in performance of their respective missions. Since these powers were broadly stated and were given on a continuing basis, it was not necessary to renew these powers in the same manner as it was necessary to make appropriations each year as a basis for the power to obligate and spend money. By shaping the appropriations and making the execution of the budget under such appropriation subject to reprogramming arrangements, the Appropriations Committees were, in effect, defining the manner in which the substantive power would be exercised. When such reprogramming was applied in the establishment of a shopping list in the area of major procurements, it would, for example, define and specify the major weapon systems available to the military departments.

For this reason, the Armed Services Committees sponsored legislation which required that any subsequent appropriations for aircraft, missiles or naval vessels must be preceded by authorizing legislation supporting such appropriations.<sup>10</sup> This legislation had the effect of incorporating the Armed Services Committees into the business of annually defining the basic budget programs to be executed under the broad appropriations. While the restriction did not embrace all of the defense appropriations, it was sufficient to cover the procurement of the major weapons systems.

Rather than narrowing control to the authorization of specific weapon systems, the Armed Services Committee would introduce a bill which was as broad in its authorization as the spending authorization contained in the respective appropriations. For this reason, it became necessary for any reprogramming actions which had to be reviewed by the Appropriations Committee to be similarly staffed through the Armed Services Committees of both Houses. Accordingly, any reprogramming actions taken with respect to funds made available for financing the procurement of aircraft, missiles and naval vessels are submitted to the House and Senate Armed Services Committees, as well as the Appropriations Committees of both Houses.<sup>11</sup> Accordingly, the standards of reprogramming were changed so that particular attention could be given to the action required under the legislation reported by the Committees on Armed Services in compliance with Section 412(b) of the Military Construction Act of 1959.<sup>12</sup>

<sup>10</sup> Military Construction Act of 1959, tit. IV, § 412(b), 73 Stat. 302 (1959).

<sup>11</sup> S. Rep. No. 253, 87th Cong., 1st Sess. 3 (1961); H.R. Rep. No. 380, 87th Cong., 1st Sess. 10 (1961).

<sup>12</sup> 73 Stat. 302 (1959).

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### D. OBLIGATION CONTROL

It should be noted that the control established by Congress relates to the execution of budget programs under particular appropriations. The Budget has been managed and continues to be managed by the Executive Branch on the basis of the right to obligate contained in the appropriations. The control of Congress over the Executive Branch has been and continues to be primarily a control of the authority to obligate funds. Since the appropriation does not set the annual rate of liquidation of obligations, there is no congressional annual expenditure control in terms of annual revenues. The responsibility for this annual expenditure control, which becomes the basis for balancing the budget—Le., matching budget revenues to budget expenditures—is the responsibility of the President. The President limits the right of obligation through the apportionment authority exercised by the Director of the Bureau of the Budget.<sup>13</sup> This authority is contained in the Anti-Deficiency Act,<sup>14</sup> which requires that obligation control, as expressed in the apportionment made by the Director of the Bureau of the Budget, be continued through all of the administrative subdivisions of funds resulting from the allocations, allotments, and suballotments made by the various agencies in the Executive Branch.

### E. DEPARTMENT OF DEFENSE CONTROL

In the Department of Defense the control of funds goes beyond that required by the Anti-Deficiency Act. The Secretary of Defense is required by statute<sup>15</sup> to establish an obligation rate against all appropriations at the beginning of each year before such funds become available for use throughout the Department of Defense. In establishing this rate, the amounts are tied into the apportionments expected to be made and become, in part, the basis for the financial plan governing all of the obligation and preobligation action of the ensuing fiscal year. At the same time, expenditure targets are set within the limitations contained in the President's Budget. These expenditure targets are not subject to the Anti-Deficiency Act and are primarily related to the anticipated liquidation of obligations in existence or coming due in the ensuing fiscal year.

Thus, it can be seen that, within the Department of Defense, the control of the programs within the budget is found in a finan-

<sup>13</sup> Rev. Stat. § 3679 (1875), as amended, 31 U.S.C. § 665(d) (2) (1958). 1464 Stat. 765 (1950), 31 U.S.C. § 665(a)-(i) (1958).

<sup>15</sup> National Security Act Amendments of 1949, ch. 412, § 11, 63 Stat. 585, 5 U.S.C. § 172c (1958).

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cial plan based primarily on the obligation rate permitted under outstanding appropriations. The obligation control, which was established initially by Congress in the appropriation, is carried out through the various levels of control in the Department of Defense. However, even with this breakdown, the identity of the appropriation has not been changed. This is true even in the breakdown of an appropriation by the military departments, where appropriations may be subdivided into budget activities and budget programs. These programs are not programs of action independent of the right to obligate, even though they may find their definition in connection with the execution of military plans of the department concerned. Any violation of a fund limitation in this program area would be subject to the provisions of the Anti-Deficiency Act. In this context the governing control is the use of funds rather than the definition of the program to be pursued.

### F. *MILITARY PLANNING*

Prior to the initiation of defense programming, the military departments did their planning on a long-range basis in accordance with the plan established by the Joint Chiefs of Staff. The joint plan of the Joint Chiefs of Staff would, of course, be responsive to the basic national security policy objectives established by the National Security Council. These objectives were translated by the Joint Chiefs of Staff into a joint long-range strategic estimate. Thereafter, a joint strategic objectives plan would be formulated. The military departments would then establish their own military objectives consistent with the joint strategic objectives plan. This, in turn, would be further translated into requirements for the budget structure and finally emerge as programs within a segment of a particular appropriation.

As a result, the operational plans of the military departments were only expressed as programs in the appropriation structure and not as one of the budget subdivisions presented to Congress (except in the case of major procurement and military construction). These programs were expressed primarily in terms of missions specifically assigned to the military departments. Planning was tied into the funds at a level convenient to the operational requirements of the military departments with only broad guidance from the Joint Chiefs of Staff or the Office of the Secretary of Defense. This practice of establishing a budget program structure as a guide to management action terminated with the budget established for the fiscal year 1962.

# NEW DEFENSE PROGRAMMING CONCEPT

## 111. DEFENSE PROGRAMMING

For fiscal year **1963** a budget, based on the defense programming concept, was established by Secretary of Defense McNamara. The end purpose of this programming, as reflected in its structure, was to integrate, on a continuing basis, the changing national security objectives and plans with the funds currently available as well as those reasonably expected to be available over the next five years. This would permit rapid shifts in requirements under constantly changing plans to be expressed in complementary shifts in the fund structure.

Defense programming consists of three essential ingredients. First, it is necessary that a financial base for the program be created and maintained which, at any given time, will reflect, on a cost basis, the requirements established by the planning process. This program financial base then becomes the official guide, not only for the purpose of seeking new appropriations, but also for the purpose of utilizing existing appropriations. Defense programming serves the dual purpose of formulating a program and executing the program. For this reason, the second essential ingredient of defense programming is that it have the capacity to be changed or altered on a continuing basis in response to changing military plans. Finally, the third ingredient calls for the providing of progress reports to top management, which will measure scheduled performance, euphemistically called "milestones."

### A. INITIAL EVOLUTIONARY STEPS

In establishing the budget for the fiscal year **1963**, the first effort was directed towards the establishment of the program financial base. This base developed from the evaluation by the Secretary of Defense of the requirements necessary to satisfy the over-all national security objectives. Instead of filtering these requirements through the Joint Chiefs of Staff and the military departments for final expression as guidelines for a budget, the nine major military programs became the basic over-all guide for planning the **1963** Budget as well as for projecting the force structure and financing requirements for the next five fiscal years. This guide, in turn, was reduced to elements which made up the major military programs. These programs are set forth in blue-covered texts, which were referred to by the military as the "Blue Streak." The "Blue Streak" finally became the basis for evolving the particular program elements attached to each major program.

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### ***B. PROGRAM ELEMENTS***

Program elements are expressed in summary fashion on a program element summary data sheet, which shows the specific component force structure of the characteristics of the program element for a period of eight years, as well as the total obligational authority for the current and succeeding five fiscal years intended to be utilized in support of the program element. The program element is broken down into three primary cost categories of Research and Development, Investment, and Operating Costs for each of these years. The research and development costs are those costs (including related construction) primarily associated with the development of a new capability to the point where it is ready for introduction into operational use. Investment costs would be those costs (including related construction) beyond this point, whereas the operating costs would be those recurring costs required to operate and maintain the capability throughout its projected life.

### ***C. FIVE YEAR FORCE STRUCTURE AND FINANCIAL PROGRAM***

The sum total of these program elements add up to the "Five Year Force Structure and Financial Program," which has been approved by the Department of Defense. This is the basic program financial base on which all action of the Department of Defense is taken. Although it is the financial base, it is not the funding guide of the Department of Defense. Funding authority continues to follow the traditional lines of appropriation, apportionment, allocation, allotment and suballotment, and it is only through these traditional methods that the authority to obligate is obtained and exercised. The authority to obligate is not found in the program structure. No financial planning in the programming structure is to be considered as funding authorization or as a funding limitation. Yet, the program structure must be considered as the area of operations in the same manner as substantive legislation at congressional levels defines the area of use in which the funding structure is expressed.

### ***D. MATERIAL ANNEX***

In addition to the program elements, a material annex comparable to the shopping list heretofore given to the congressional committees is also established. This material annex lists all of the major procurement for items which may be distributed through many program elements but which consist, in the aggregate, of procurement of a single item in a particular year of two

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million dollars or more. Thus, not only are the program elements established as guides of action, but major procurement action in significant amounts are similarly controlled.

### E. PROGRAM CHANGES

The military departments are permitted to operate within this program financial base and make changes without the prior approval of the Secretary of Defense when the amounts are below certain ceilings or thresholds established by the Secretary of Defense under a program change control system.<sup>16</sup> These thresholds relate to the three cost categories of research and development, investment, and operating cost, as well as changes in the total force structure. In the case of the Military Assistance Program, a special threshold has been established.

As a result of the program change control system, no changes may be made without the approval of the Secretary of Defense in the five-year force structure and financial program, if such change results in the increase of forces or manpower or the introduction of a new program element in the category of research and development ; nor may changes in the amount of 10 million dollars or more, in the current or budget fiscal year, be made in the category of research and development or investment in any particular element or item in the material annex without the approval of the Secretary of Defense. Construction line items of 5 million dollars or more require the approval of the Secretary of Defense. Where changes involve years beyond the current or budget fiscal year, the total change in any program element or material annex cannot be 25 million dollars or more without approval, even though such change may involve an amount less than 10 million dollars in the current or budget fiscal year. In the case of operating costs, changes in program elements which are 10 per cent or more in any one year, and involve an amount of 10 million dollars or more, require approval of the Secretary of Defense. The Military Assistance Program requires approval wherever a change may be one million dollars or more in any one country in any one year. Items under development require approval of the Secretary of Defense where such items have total costs of 10 million dollars or more and are approved for procurement and deployment.

Where approval is obtained for such changes, it is necessary that the program element summary data and the material annex be revised so that the document in the book reflects the effect of

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<sup>16</sup> Dep't of Defense Directive No. 7045.1 (April 12, 1962) ; Dep't of Defense Instruction No. 7045.2 (April 17, 1962).

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the most recent change made. For changes below the threshold not requiring Secretary of Defense approval, the documents are updated and submitted on May 1, August 15, and in December, and at such other times as the Secretary of Defense may direct. As stated previously, the resultant document becomes both a guide for establishing the budget as well as a guide for the program in budget execution. Only programs in the Department of Defense program book are approved and eligible for such execution.

### IV. BUDGET PROGRAMS AND DEFENSE PROGRAMMING

#### A. *RELATION TO APPROPRIATION STRUCTURE*

Since every element in the major military programs evolve through the stages of research, development, procurement, construction, production and, finally, operation, it becomes apparent that any element in defense programming can, at a single time, embrace all of the appropriations in the Department of Defense appropriation act. This is not true of budget programs. Budget programs, which are controlled under the reprogramming arrangement with the congressional committees, are segments of particular appropriations and have a direct relation to the fund structure. Defense programming must be segmented if it is going to be capable of expressing itself in budget formulation and execution as presently prescribed by Congress.

The effectiveness of defense programming will be tested by the extent to which the segmentation of the categories in the particular program elements will permit identification with the appropriation structure. This has been accomplished in regard to the reporting of appropriation usage for each of the categories in particular elements. Through the ingenious use of computers, the military departments are capable of analyzing their obligation effort so that facts relevant to the defense programming structure can be produced within the present appropriation structure. However, it must be recognized that the reduction of any function to its components results in the loss of the identity of the function, and a summary of the components within another classification does not give direction to budget program execution, even though it reflects progress in defense programming execution.

Although there will be reconciliation with the total amounts of a given appropriation in a given year, such reconciliation does not indicate the particulars of usage necessary in the control of a budget program. Fortunately, many of the budget programs, particularly in the case of those found in the continuing appropriations, such as major procurement, military construction, and

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research, development, test and evaluation are identical with the cost categories contained in a program element. This results, in part, from the fact that the budget shopping list given to the Congress tends to coincide, in the major weapon system area, with the material annex and the investment breakdowns contained in the individual program elements.

The area of difficulty, as far as reconciliation with the program elements is concerned, lies primarily in the distribution of operating and personnel costs. No difficulty is experienced in keeping the total number of military and civilian personnel within the basic year-end strength totals established. The difficulty lies in the distribution of this total in such a manner that there will be match-out horizontally and vertically in a checkerboard fashion with the budget programs on one hand and the defense program elements on the other. This has led the keepers of the statistics, the budget figures and the plans to talk in terms of "parameters," "matrices" and even "interfaces," which obviously have their origin in a specialized field of mathematics.<sup>17</sup> Use of these terms does not contribute to the general understanding of the over-all problem when included in regulations ostensibly explaining the relationships of the old and the new.

### B. PROGRESS REPORTING

In addition to establishing the force structure of the U.S. military power, the planning of resources requires that the composition, level, and deployment of military units in any particular fiscal year be correlated with the weapon systems and equipment which bring about the planned strength of United States forces in those years. Once the physical resources have been determined, it becomes necessary to measure the progress of acquisition not only in terms of dollars spent, but also in terms of the actual presence of such physical resources in the force structure. It is not enough to know that obligations were created for the procurement of tanks, but it is also necessary to know that the tanks have been delivered and are in the hands of the fighting forces in the places and at the times established within the planned deployment and composition of these military units.

The authority to obligate is merely the initial action in the acquisition of physical resources and is a satisfactory measure for showing timely utilization of funds appropriated. However, it is an insufficient measure of the progress of approved acquisition

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<sup>17</sup> The general dictionary meaning of these words is not helpful in understanding their usage. See any text of mathematics treating with differential geometry, *e.g.*, Newman, *World of Mathematics* (1956).

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plans in terms of physical accomplishment. For this reason, it becomes necessary that progress be reported in terms of deliveries made in the case of major procurement, stage of completion in the case of military construction, and levels of accomplishment as reflected in the milestones established for the research and development categories. This will require extensive changes in the accounting and reporting systems which have been oriented to fund control rather than to performance in terms of physical units of measure. With the establishment of levels of physical accomplishment, management is placed in a position where it can evaluate subsequent performance against planned projections. In addition, if physical accomplishment does not parallel a prorated use of resources, management can then determine what action should be taken to accelerate production, or even in some instances to abandon a nonproductive project.

It is expected that reporting will be done on a quarterly basis, on both financial and nonfinancial data, by resource categories. This reporting will not be a part of the obligation control exercised under the fund structure, which will continue to be apportioned, allocated and allotted as it has been in the past. Although the laws and regulations which govern accounting procedures have been directed in the past toward a detailed control of **funds**,<sup>18</sup> the accounting requirements under programming are pointed toward a greater control of property acquisition and application, in order to measure the accomplishment of program projections. Physical inventory can be more meaningful to management as a measure of effective use of funds than obligations and expenditures.

### C. DECISION PROCESS

Defense programming has brought decision making, in terms of the composition of the force structure and the employment of resources, to the highest level of the Department of Defense. The programming structure has been organized around nine major programs which are directly related to the national security policy objectives. Decisions covering the program elements that are segments of these nine major programs will, because of this structure, further the use of effective resources dictated by current strategic considerations. The program elements are quite detailed, and, for this reason, must supersede the particular objectives pursued by the military departments at their own levels of control. The over-all defense requirements become the measures

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<sup>18</sup> See Office of Gen. Counsel, U.S. Dep't of Navy, *Navy Contract Law*, ch. 4 (2d ed. 1959, Supp. 1961); U.S. Dep't of Army, *Pamphlet No. 27-153*, ch. 2 (1961).

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**of** usage of any particular resource held by any military department, and the program elements must fit into the total force structure and financial program of the Department of Defense. Defense programming not only measures and reports performance, but also directs the required performance at a tempo consistent with the total needs projected for the current fiscal year or any of the five succeeding fiscal years.

In time the procedures will be refined and improved, and, in all probability, action under the fund structure and under the programming structure will be brought together. Then budget programs and program elements will become sufficiently similar so as to permit a budget presentation completely harmonious with programming and the budget requirements of the congressional committees.



# PROPRIETARY DATA IN DEFENSE PROCUREMENT\*

BY WILLIAM MUNVES\*\*

## I. ARMED SERVICES PROCUREMENT REGULATION DEFINITION OF PROPRIETARY DATA

The Armed Services Procurement Regulation,' which will, for brevity's sake, be called the "Regulation," sets forth in Part 2, Section IX thereof, the Department of Defense policy, implementing instructions and contract clauses with respect to the acquisition and use of data. The key to the Regulation is to be found in the statement that "it is the policy of the Department of Defense to encourage inventiveness and to provide incentive therefor by honoring the 'proprietary data' resulting from private developments and hence to limit demands for data to that which is essential for Government purposes."<sup>2</sup>

The term "proprietary data" is defined by the Regulation as meaning "data providing information concerning the details of a contractor's secrets of manufacture, such as may be contained in but not limited to its manufacturing methods or processes, treatment and chemical composition of materials, plant layout and tooling, to the extent that such information is not disclosed by inspection or analysis of the product itself and to the extent that the contractor has protected such information from unrestricted use by others."<sup>3</sup> This definition was introduced into the Regulation in the revision of October 15, 1958. It revised somewhat an earlier, similar definition prescribed in the initial Part 2 of April 9, 1957.<sup>4</sup> Both definitions are predicated on the common law

\* The opinions and conclusions presented herein are those of the author and do not necessarily represent the views of the Department of the Air Force, The Judge Advocate General's School nor any other governmental agency.

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<sup>1</sup> Armed Services Procurement Reg. § 9, pt. 2 (July 1, 1960) (hereinafter cited as ASPR).

<sup>2</sup> ASPR 9-202.1(a) (July 1, 1960).

<sup>3</sup> ASPR 9-201 (b) (July 1, 1960).

<sup>4</sup> ASPR 9-201(c) (April 9, 1957), defined proprietary data as meaning "data providing information concerning the details of the contractor's trade secrets or manufacturing processes which are not disclosed by the design itself and which the contractor has a right to protect from use by others."

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concept of a trade **secret**.<sup>5</sup> Whether the current definition equates "proprietary data" with "trade secrets," or has introduced a substantial modification in the legal principles underlying trade secrets, will be reserved for later consideration. The objective, however, was to closely identify the terms "proprietary data" and "trade secret" in formulating and implementing the basic procurement policy governing the acquisition of technical data. This recognition accorded proprietary rights in data by the Regulation represents the first such expression of policy by the Department of Defense.

### II. EXPERIENCE AND PROBLEMS UNDER THE REGULATION

The experience of the five years that the Regulation has been in effect has revealed serious deficiencies. Elements of industry are still vociferously contending that the Government is not honoring proprietary data. There is a widespread divergence of interpretation by industry of the definition of "proprietary data" as, used in the Regulation, both at the bargaining table and in discharging its contract obligations. As a result, the Government is frequently not obtaining technical data in complete and usable form for its intended application or, at a minimum, is involved in endless disputes as to its rights in data actually delivered because of questionable restrictive markings or claims of ownership even in the absence of such limiting legends.

The principle of recognizing proprietary data is, of course, unassailable. This article will concentrate on the problems raised by the Regulation's treatment of proprietary data, with particular emphasis on the consequence of its inclusion as a term in the contract for the purpose of describing or identifying data to be delivered or omitted. It is not the purpose of this article to probe other facets of the Regulation which have given rise to a myriad of data problems in procurement and contract administration. For example, no attempt will be made to probe the basic questions arising from the conflict of interest engendered by the Department's commitments on the one hand to honor proprietary information by not calling for it, or taking it subject to limited use, and, on the other hand, to fulfill its assurances to the Congress to obtain complete data essential for procurement so as to

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<sup>5</sup> No substantive difference was intended in changing to contractor's secrets of manufacture, etc. The revised definition substituted two categories of data, "proprietary" and "other" data, for the previous three categories, "operational," "design" and "proprietary" data. The revision made it clear that design and proprietary data were not mutually exclusive. The ambiguity had been objectionable to industry.

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broaden the field of competitive buying. Nor will any effort be made to delve into the metaphysics of predetermining at what point in time it will be economical in the constantly changing weapons systems, affected as they are by technological and engineering improvements and changes in missions, to obtain complete reprourement data, or what price should be paid for proprietary data inevitably associated with such procurement data packages. Whatever be these problems and their solution, it is worth noting that their genesis is likewise to be found in the words "proprietary data."

It is not to be presumed that the Regulation is solely to blame for the current dilemma. The problem of proprietary data long preceded the Regulation. For many years the rumblings were heard on the battle line of procurement—the "field," and finally, industry launched its critical attack upon the headquarters in the Pentagon.

Industry pointed out that there was no published policy for data; that certain procurement offices were demanding full rights in all data, without according appropriate recognition to the contractor's proprietary rights in data; and that there was consequently a lack of uniformity in the demands for data. The Regulation followed after years of study, industry consultation and interminable drafts. The initial Regulation published on April 9, 1957,<sup>6</sup> was hardly in print when a clamor arose for revisions. A year and a half later the present version was adopted.

### III. WHEN PROPRIETARY DATA REQUIRED

How does the definition affect procurement? At the very outset a contractor may question the Government's requirement for data which the contractor regards as proprietary because the Regulation states, as basic policy, that "Generally it should not be necessary to obtain 'proprietary data' to satisfy Government's requirements."<sup>4</sup> In addition, in advertised procurement and in contracts and subcontracts for standard commercial items it is provided that proprietary data shall not be requested.<sup>5</sup> In the case of a research and development contract, a contractor may demand payment for proprietary data for items which it has developed at its own expense but which it has not previously sold or offered for sale. Moreover, he is exempted both by the Regulation and the prescribed data clauses from providing proprietary information

<sup>6</sup> ASPR 9-201(c) (April 9, 1957).

<sup>7</sup> ASPR 9-202.1(a) (July 1, 1960). The requirements for proprietary data are more prevalent in practice than the policy would indicate and contractors, reluctant to provide such data, have made this an issue during negotiations.

<sup>8</sup> ASPR 9-202.1(b) (July 1, 1960).

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for standard commercial items, or those which were developed at private expense and previously sold or offered for sale.<sup>9</sup> In the negotiated supply contracts he can omit proprietary information from the data to be delivered or, when specifically required by the contract, may supply it subject to limitation as to its use,<sup>10</sup> or may provide it for reprourement purposes for a price separately negotiated.<sup>11</sup>

In summary, therefore, the contractor may, where the policy inhibits the procurement of proprietary data, challenge the Government's requirements for complete manufacturing data or, depending on the contract provisions, either omit proprietary data from the data package or furnish it subject to restrictive markings. In appropriate cases, the contractor may demand that the furnishing of proprietary data be the subject of a separate price negotiation.

Because of the variety of circumstances in which it may be furnished-or omitted—there must be a common understanding or, in the basic tenet of contract law, “a meeting of the minds,” as to what precisely constitutes proprietary data in a given procurement. Let us, therefore, examine the yardstick which the Regulation provides to Government and contractor personnel concerned and, in the case of disputes, to the Board of Contract Appeals, the definition of “Proprietary Data,” and then evaluate the suitability of its use as a contract term.

### IV. RELATION OF PROPRIETARY DATA TO TRADE SECRET

#### A. *IN GENERAL*

It was stated earlier that proprietary data is identified with the common law concept of a trade secret. Since the ASPR is not written for lawyers, but for the average contracting officer and buyer, it must define its terms in a manner that can be commonly understood by non-lawyers for practical application, and be appropriate regardless of the jurisdiction in which the contract is made or administered. It must be stated simply and concisely. The definition of proprietary data, therefore, does not purport to embrace fully all factors and legal considerations that constitute a trade secret. As a result it glosses over factors which are com-

<sup>9</sup> ASPR 9-202.1(c) (July 1, 1960).

<sup>10</sup> ASPR 9-203.3 (Feb. 16, 1962), provision (j) prescribed therein for addition to basic data clause. Generally speaking, limitation as to use precludes release outside of Government for duplication, use or disclosure, in whole or in part, for procurement or manufacturing purposes other than emergency manufacture under conditions described in provision (j).

<sup>11</sup> ASPR 9-202.1(b) (July 1, 1960).

plex, defy precise delineation and lend themselves to a variety of interpretations. As shall be seen, there are divergent legal theories even as to the basis for affording legal protection for trade secrets.

In order to appreciate the ramifications of the definition problem, such authoritative sources as the Restatement of Torts, case law, and the views expressed in an outstanding current text on the subject will have to be considered.

B. *DEFINITION OF A TRADE SECRET—RESTATEMENT OF TORTS*

The most authoritative single source for the definition of a trade secret is to be found in the following extract from the Restatement of Torts:

*Definition of trade secret.* A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers. It differs from other secret information in a business . . . in that it is not simply information as to single or ephemeral events in the conduct of the business, as, for example, the amount or other terms of a secret bid for a contract or the salary of certain employees, or the security investments made or contemplated, or the date fixed for the announcement of a new policy or for bringing out a new model or the like. A trade secret is a process or device for continuous use in the operation of the business. Generally it relates to the production of goods, as, for example, a machine or formula for the production of an article. It may, however, relate to the sale of goods or to other operations in the business, such as a code for determining discounts, rebates or other concessions in a price list or catalogue, or a list of specialized customers, or a method of bookkeeping or other office management.

*Secrecy.* The subject matter of a trade secret must be secret. Matters of public knowledge or of general knowledge in an industry cannot be appropriated by one as his secret. Matters which are completely disclosed by the goods which one markets cannot be his secret. Substantially, a trade secret is known only in the particular business in which it is used. It is not requisite that only the proprietor of the business know it. He may, without losing his protection, communicate it to employees involved in its use. He may likewise communicate it to others pledged to secrecy. Others may also know of it independently, as, for example, when they have discovered the process or formula by independent invention and are keeping it secret. Nevertheless, a substantial element of secrecy must exist, so that, except by the use of improper means, there would be difficulty in acquiring the information. An exact definition of a trade secret is not possible. Some factors to be considered in determining whether given information is one's trade secret are: (1) the extent to which the information is known outside of his business; (2) the extent to which it is

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known by employees and others involved in his business; (3) the extent of measures taken by him to guard the secrecy of the information; (4) the value of the information to him and to his competitors; (5) the amount of effort or money expended by him in developing the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others.

*Novelty and prior art.* A trade secret may be a device or process which is patentable; but it need not be that. It may be a device or process which is clearly anticipated in the prior art or one which is merely a mechanical improvement that a good mechanic can make. Novelty and invention are not requisite for a trade secret as they are for patentability. These requirements are essential to patentability because a patent protects against unlicensed use of the patented device or process even by one who discovers it properly through independent research. The patent monopoly is a reward to the inventor. But such is not the case with a trade secret. Its protection is not based on a policy of rewarding or otherwise encouraging the development of secret processes or devices. The protection is merely against breach of faith and reprehensible means of learning another's secret. For this limited protection it is not appropriate to require also the kind of novelty and invention which is a requisite of patentability. The nature of the secret is, however, an important factor in determining the kind of relief that is appropriate against one who is subject to liability under the rule stated in this Section. Thus, if the secret consists of a device or process which is a novel invention, one who acquires the secret wrongfully is ordinarily enjoined from further use of it and is required to account for the profits derived from his past use. If, on the other hand, the secret consists of mechanical improvements that a good mechanic can make without resort to the secret, the wrongdoer's liability may be limited to damages, and an injunction against future use of the improvements made with the aid of the secret may be inappropriate.<sup>12</sup>

It is evident from the foregoing that the concept of trade secrets is predicated on general principles or factors which may embrace a wide range of interpretation in their application to particular fact situations.

### C. DEFINITION OF TRADE SECRET—CASE LAW

An examination of the case law on the subject underscores the above conclusion. A sampling of judicial comments reveals neither definitiveness of meaning, nor uniformity in the application of factors in the evaluation of trade secrets.

While the rule is clear that novelty and invention are not requisite for a trade secret, as they are for patentability, the case law is obscure as to its positive characteristics. Even with the words "novelty and invention" we are dealing in shades of meaning. Thus, in *International Industries v. Warren Petroleum Corp.*,<sup>13</sup> where the trade secret alleged to have been appropriated

<sup>12</sup> Restatement, Torts § 757, comment b (1939).

<sup>13</sup> 99 F. Supp. 907 (D. Del. 1951), *aff'd*, 248 F.2d 696 (3d Cir. 1957), *cert. denied*, 355 U.S. 943 (1958).

was an economic study and plans for a new method of converting dry cargo vessels to vessels for transportation of liquidated petroleum gas, the court, in commenting on the matter of novelty and invention, stated :

One point must be kept in focus: the novelty and invention required in this type of case is not the same **as** is required for patentability. Equitable protection is given merely against breach after learning about and using another's product. The distinction between novelty for patent purposes and novelty for the purpose of **a** trade secret is supported by the authorities.<sup>14</sup>

Even if there be a clear distinction between the novelty characteristics referred to by the court, one is still in doubt as to the degree of novelty which is essential to a trade secret.

Some cases emphasize the idea of discovery as an element of trade secrets. Thus in *Sarkes Tarzian, Inc. v. Audio Devices, Inc.*,<sup>15</sup> the court states that "While they [trade secrets] need not amount to invention [sic] in the patent law sense, they must, at least, amount to discovery. It follows that matters which are generally known in the trade or readily discernible by those in the trade cannot be made secret by being so labeled in an agreement."<sup>16</sup> **As** to what constitutes "discovery" consider the following explanation :

We do not accept the plaintiff's contention that, regardless of whether processes are novel, those things which it has attempted to hide from the public will be protected against use by anyone who obtains knowledge of them through breach of confidential relation, and the master was right in rejecting it. Nevertheless, in endeavoring to ascertain whether the processes were novel, the master seems to have applied the test of invention recognized by the patent law and to have held invalid all processes which appeared to him to be within expected mechanical skill. It is agreed, and we think correctly, that processes which are not patentable may yet be the subject of trade secrets. . . .

To entitle one to **a** patent, there must be invention. The applicant must have exercised some degree of ingenuity, displayed some flash of genius, inspiration or imagination, not within the reach of mere artisanship. . . . A process may, however, be maintained in secrecy and be entitled to equitable protection even though invention is not present. The cases which deal with the elements necessarily present in **a** proprietary process are careful to define such processes **as** resulting from invention, or discovery. . . . Quite clearly discovery is something less than invention. Invention requires genius, imagination, inspiration, or whatever is the faculty that gives birth to the inventive concept. Discovery may be the result of industry, application, or be perhaps merely fortuitous. . . .

The mere fact that the means by which **a** discovery is made are obvious, that experimentation which leads from known factors to an ascertainable

<sup>14</sup> *Id.* at 914 (footnotes omitted).

15166 F.Supp. 250 (D. Colo. 1958), *aff'd*, 283 F.2d 695 (9th Cir. 1960), *cert. denied*. 365 U.S. 869 (1961).

<sup>16</sup> *Id.* at 266 (footnotes omitted).

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but presently unknown result may be simple, we think cannot destroy the value of the discovery to one who makes it, or advantage the competitor who by unfair means, or as the beneficiary of a broken faith, obtains the desired knowledge without himself paying the price in labor, money, or machines expended by the discoverer.<sup>17</sup>

Compare the foregoing preoccupation with the need for some kind of novelty or discovery to support a trade secret with the observation in a leading case that "all that is required is that the information or knowledge represent in some considerable degree the independent efforts of its claimant."<sup>18</sup> Thus even as to the generally accepted principles, there is neither uniformity nor preciseness in their application.

Another approach to the evaluation of a trade secret is reflected in the following comment of the Supreme Court of Texas in *Wissman v. Boucher*:<sup>19</sup>

There is no patent or claim of patentable device in respect of the pole [referring to a metallic fishing rod that would collapse into one piece and serve as a walking stick] as made by the plaintiff, and while the evidence is as confused as it is abundant it seems clear enough that, even making the doubtful assumption of novelty in the plaintiff's idea, his pole is based on familiar mechanical means and principles that are quite obvious to and easy to imitate by any reasonably experienced machinist that might see one for the first time or purchase it on the open market. Under these latter circumstances, the exposure of the device to the public by advertisement or sale definitely operates to destroy any legal protection the claimed originator might otherwise assert on the basis of a trade secret.<sup>20</sup>

The same court, in a subsequent case<sup>21</sup> involving a different kind of fishing pole, a magnetic one used to recover parts of broken drills, drilling bits and other foreign metallic materials from oil wells, distinguishes that pole from the "simple and obvious" product in the *Wissman* case, *supra*, as follows:

The record in the present case indicates that the K & G tool is no simple device, "the construction of which is ascertainable at a glance." The use of a magnet to attract metallic substances is of course devoid of novelty. The making of a tool embodying this principle which is effective in meeting the needs of the industry in clearing well holes of deleterious metal particles is another matter. The record shows numerous patents have been issued for "magnetic fishing tools" and that much work and ingenuity have been applied to the development of a practical and successful device.<sup>22</sup>

<sup>17</sup> *A. O. Smith Corp. v. Petroleum Iron Works Corp.*, 73 F.2d 531 (6th Cir. 1934); *accord*, *Brown v. Fowler*, 316 S.W.2d 111 (Tex. Civ. App. 1958).

<sup>18</sup> *Smith v. Dravo Corp.*, 203 F.2d 369, 373 (7th Cir. 1953).

<sup>19</sup> 160 Tex. 326, 240 S.W.2d 278 (1951).

<sup>20</sup> *Id.* at 330, 240 S.W.2d at 279.

<sup>21</sup> *K & G Oil Tool and Service Co. v. G & G Fishing Tool Service*, 158 Tex. 694, 314 S.W.2d 782 (1958), *cert. denied*, 358 U.S. 898 (1958), *rehearing denied*, 359 U.S. 921 (1959).

<sup>22</sup> *Id.* at 605-6, 314 S.W.2d at 790.

The opinion then pinpointed the problem inherent in endeavoring to delineate those ideas, processes or products which are comprehended by the concept of the law of trade secrets:

In the law of trade secrets, embracing mechanical engines, chemical formulae, confidential lists and the like, matters ranging from sugar in tea for sweetening purposes to the most complicated machines will be encountered. Questions as to classification will arise and their solution **may** not always be free from difficulties. Examples may be more helpful than definition or attempted redefinition.<sup>23</sup>

Here again, the absence of a definitive quality which can lend itself to objective measurement is to be noted.

Interrelated with the question of novelty, discovery or originality of the disclosure, is the matter of secrecy. Even as to the latter the rule is elusive.

Consider the following remarks which are intended to shed light on the element of secrecy:

The defendants contend that the manufacture and exhibition of the machine of the plaintiff was a public disclosure of all the matters connected with it and, since it was visible to anyone who viewed it, hence there could have existed no trade secret. This element of secrecy is comparative in nature and dependent upon the facts. The protection begins and ends with the life of the secrecy and the secrecy to be protected depends upon the degree of public knowledge.<sup>24</sup>

This accords with the basic rule as enunciated in the Restatement that "Matters which are completely disclosed by the goods which one markets cannot be a **secret**."<sup>25</sup> Apropos of this rule, the court, in *Sandlin v. Johnson*,<sup>26</sup> found that:

[T]he record warrants the view that the structure of improvements and their machine-combination was readily revealed by an inspection, and in this situation the sales which plaintiff had made generally to the trade, together with the demonstrations which they willingly afforded any inquirer about the machine, were entitled to be held to have constituted a public disclosure.?

But the fact that disclosure by inspection would seem to bar a claim of secrecy presumably because it affords anyone knowledgeable in the trade an opportunity to duplicate or copy the product is complicated by another rule. If information or data of the nature of a trade secret covering an item which could be duplicated is accepted in confidence, such information or data will be treated as protected against disclosure or improper use by the recipient.<sup>25</sup> Thus, the mere fact that an item, with respect to

<sup>23</sup> *Ibid.*

<sup>24</sup> *Newell v. O. A. Newton & Sons Co.*, 104 F.Supp. 162, 166 (D. Del. 1952).

<sup>25</sup> Restatement, Torts § 757, comment *b* (1939).

<sup>26</sup> 152 F.2d 8 (8th Cir. 1945).

<sup>27</sup> *Id.* at 11.

<sup>28</sup> *Smith v. Dravo Corp.*, *supra* note 18, *remanded with directions*, 208 F.2d 388 (7th Cir. 1953).

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which information is disclosed in confidence, could have been reproduced without such information is not a controlling factor where there is an express or implied contract, or a confidential relationship otherwise established, to receive the information in confidence.

The secrecy rule is not only vague in application; in some instances the case law is in conflict. In one case it was held that secrecy was not compromised because of the fact that it was learned after information was disclosed in confidence that a patent covering such information had previously been issued and had expired, but was at the time of disclosure generally unknown.<sup>29</sup> In another it was held that "if a discovery is one which constitutes an invention and for which a patent is issued, the right of further secrecy is, of course, lost, for a legal disclosure and public dedication have then been made. . . ."<sup>30</sup> Similarly, as to whether one who has unlawfully obtained or used information constituting a trade secret is free to do so after the patent disclosure of the information in question, there is a divergency of views. Thus, in *Conmar Products Corp. v. Universal Slide Fastener Co.*,<sup>31</sup> Judge Learned Hand comments as follows:

Since the specifications of the patents in suit disclosed the first six secrets and part of the seventh, that much of the secrets upon issue of the patents fell into the public demesne; and, prima facie, the defendants were free to use them. The Seventh Circuit and apparently the Sixth as well, have, however, held that if before issue one has unlawfully obtained and used information which the specifications later disclose, he will not be free to continue to do so after issue; his wrong deprives him of the right which he would otherwise have had as a member of the public. We have twice refused to follow this doctrine; and we adhere to our decisions. Conceivably an employer might exact from his employees a contract not to disclose the information even after the patent issued. . . . Be that as it may, we should not so construe any secrecy contract unless the intent were put in the most inescapable terms. . . .<sup>32</sup>

### D. PROTECTION OF TRADE SECRETS — DIFFERENT THEORIES

The very basis for affording protection for a trade secret finds support in various rationales. It may be predicated on property rights<sup>33</sup> in the trade secret, breach of contract<sup>34</sup> or of a general

<sup>29</sup> *Benton v. Ward*, 59 Fed. 411 (D. Iowa 1894).

<sup>30</sup> *Sandlin v. Johnson*, 141 F.2d 660, 661 (8th Cir. 1944).

<sup>31</sup> 172 F.2d 150 (2d Cir. 1949).

<sup>32</sup> *Id.* at 155 (footnotes omitted).

<sup>33</sup> *Herold v. Herold China & Pottery Co.*, 257 Fed. 911 (6th Cir. 1919); *Dollac Corp. v. Margon Corp.*, 164 F.Supp. 41 (D.N.J. 1958) (dictum) (application for patent waives rights to trade secret therein).

<sup>34</sup> *Aktiebolaget Befors v. United States*, 194 F.2d 145 (D.C. Cir. 1951).

duty of good faith or confidence,<sup>35</sup> unfair competition,<sup>36</sup> or a combination of any of the foregoing. The Restatement contains the following comment :

There is considerable discussion in judicial opinions as to the basis of liability for the disclosure or use of another's trade secrets. Analogy is sometimes found in the law of "literary property," copyright, patents, trademarks and unfair competition. The suggestion that one has a right to exclude others from the use of his trade secret because he has a right of property in the idea has been frequently advanced and rejected. The theory that has prevailed is that the protection is afforded only by a general duty of good faith and that the liability rests upon breach of this duty; that is, breach of contract, abuse of confidence or impropriety in the method of ascertaining the secret. Apart from breach of contract, abuse of confidence or impropriety in the means of procurement, trade secrets may be copied as freely as devices or processes which are not secret. One who discovers another's trade secret properly, as, for example, by inspection or analysis of the commercial product embodying the secret, or by independent invention, or by gift or purchase from the owner, is free to disclose it or use it in his own business without liability to the owner.<sup>37</sup>

The categorization of trade secrets as "property" is still invoked, if equity demands it, notwithstanding Justice Holmes' observation in *E. I. DuPont Powder Co. v. Masland*<sup>38</sup> that:

The word property as applied to trade-marks and trade secrets is an unanalyzed expression of certain secondary consequences of the primary fact that the law makes some rudimentary requirements of good faith.<sup>39</sup>

Thus, Callman makes this appraisal in his treatise:<sup>40</sup>

The basis for protecting trade secrets remains anything but clear in theory. "In some cases [protection] has been referred to property, in others to contract, and in others, again, it has been treated as founded upon trust or confidence, meaning . . . that the Court fastens the obligation on the conscience of the party, and enforces it against him in the same manner as it enforces, against a party to whom a benefit is given, the obligation of performing a promise, on the faith of which the benefit has been conferred." Though these different grounds are still mentioned as the basis of protection, the question as to which is the true basis hangs as a doubt over almost every case in which trade secrets are involved.<sup>41</sup>

It is not necessary, for the purposes of this article, to dwell at greater length either on the common law definition of a trade secret or the rationale supporting it. Let us now appraise the Regulation's definition in the light of the foregoing analysis.

<sup>35</sup>E. I. DuPont de Nemours Powder Co. v. Masland, 244 U.S. 100 (1917).

<sup>36</sup>Pressed Steel Car v. Standard Steel Car Co., 210 Pa. 464, 60 Atl. 4 (1905) (by implication).

<sup>37</sup>Restatement, Torts § 757, comment a (1939).

<sup>38</sup>Note 35 supra.

<sup>39</sup>244 U.S. at 102.

<sup>40</sup>2 Callman, The Law of Unfair Competition and Trademarks (2d ed. 1950).

<sup>41</sup>*Id.* § 51 (footnotes omitted).

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### E. ANALYSIS OF ASPR DEFINITION OF PROPRIETARY DATA

The analysis of the ASPR definition of "Proprietary Data"<sup>42</sup> permits, as a possible interpretation, the conclusion that if the end product, or any component, treatment or chemical composition, could be ascertained by what is commonly referred to as "reverse engineering," regardless of the expenditure of time, money, effort and skill, none of the information thus obtainable can be considered in the category of a trade secret. This has been the subject of industry's principal criticism of the definition.<sup>43</sup> Contractors were quick to point out that under so sweeping a formula, almost nothing could qualify as a trade secret. At a minimum it would rule out features of design. They attacked this element of the definition as being contrary to the prevailing law.<sup>44</sup>

The matter of proprietary rights and data was the subject of hearings held by a subcommittee of the House of Representatives Select Committee on Small Business in 1960, under the chairmanship of Congressman Abraham J. Multer [hereinafter referred to as the "Multer Subcommittee"]. In testifying before the subcommittee, industry representatives were highly critical of the reverse engineering aspects of the definition.<sup>45</sup>

The point was made that the definition was not, in that respect, legally sound and in support thereof the witness cited the case of *Schreyer v. Casco Products Corp.*<sup>46</sup> and quoted therefrom as follows:

The Restatement of Torts, in defining trade secrets, states that "it [sic] may consist of any formula, pattern, device, or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. . . ."

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<sup>42</sup> ASPR 9-201 (b) (July 1, 1960): ". . . data providing information concerning details of a contractor's secrets of manufacture, such as may be contained in but not limited to manufacturing methods or processes, treatment and chemical composition of materials . . . to the extent that such information is not disclosed by inspection and analysis of the product itself. . . ." (emphasis added).

<sup>43</sup> The other element of the definition—that information to be proprietary must also have been protected by the contractor from unrestricted use by others—has been unobjectionable to contractors, and fairly reflects the requirements of secrecy. The introductory descriptive language that proprietary data means "data providing information concerning the details of a contractor's secrets of manufacture" has likewise presented no problems, although the law of trade secrets encompasses many other categories of information (customer's lists, stock quotations, business practices, etc.) since the omitted categories are not the subject of defense procurement.

<sup>44</sup> See *Smith v. Dravo Corp.*, *supra* notes 18 and 28, and cases cited therein.

<sup>45</sup> *Hearings on Proprietary Rights and Data Before Subcommittee No. 2 of the House Select Committee on Small Business*, 86th Cong., 2d Sess. 27, 30, 34, 52, 69, 109 (1960) (hereinafter cited as 1960 Hearings).

<sup>46</sup> 97 F. Supp. 159, 168 (D. Conn. 1951), *aff'd in part, rev'd in part*, 190 F.2d 921 (2d Cir. 1951), *cert. denied*, 342 U.S. 913 (1951).

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“The blueprints, blanks, lists of suppliers, cost data and information on manufacturing technique would seem to fall within the trade secret classification. It is true that matters which are completely disclosed by goods on the market are not trade secrets.”

Relying on this proposition, the defendants contend that all the information revealed by the blueprints and blanks could have been ascertained by careful analysis of the Steam-0-Matic iron which was obtainable on the market. By measuring the component parts, they say, blueprints could have been prepared and the most efficient productive method deduced. The fact remains, however, that the defendants took unwarranted advantage of the confidence which the Schreyers reposed in them and obtained the desired knowledge without the expenditure of any effort and ingenuity which the experimental analysis of the model on the market would have required. Such an advantage obtained through breach of confidence is morally reprehensible and a proper subject for legal redress.<sup>47</sup>

It need hardly be said that such an extreme interpretation of the “inspection and analysis” qualification was never intended.<sup>48</sup> The Department of Defense, in adopting the reverse engineering test, merely desired to eliminate from the category of proprietary data, such data as could *reasonably* or *readily* be derived from an inspection and analysis of the product (*i.e.*, without the expenditure of substantial time and effort). This would assure that data in the public domain, data generally known in the trade, or publicized, or data related to products which industry could and would duplicate, if it were given a chance to inspect the product

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<sup>47</sup> 1960 Hearings at 52 (quotation in hearings slightly inaccurate).

<sup>48</sup> 1960 Hearings at 175 (Letter From G. C. Bannerman, Director of Procurement Policy, Office of the Assistant Secretary of Defense (S&L), April 22, 1960, to the Committee Chairman). This letter reads, insofar as pertinent, as follows:

“We are convinced that the ‘reverse engineering’ aspect of the definition should be clarified so that Government personnel will not classify data as ‘nonproprietary’ just because the item can be reverse engineered with extensive engineering and financial effort. The cost to the Government of reverse engineering is a clue to the proprietary nature of such data. So is the time such an effort would take.

“In short, we recognize that the present definition is in need of change. Accordingly, if we are to retain the concept of ‘proprietary data,’ the definition must be sharpened so that it will include any data not readily revealed by the product itself rather than only that data which is incapable of being reverse engineered. It may be noted in passing that while this will require a change in language, it does not require a change in intention. The words ‘is not disclosed’ in the above definition were never intended to describe a process of expensive and detailed reverse engineering. The fact that they have been so interpreted dictates the necessity for a change in definition.”

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for competitive purposes, would not be withheld or subjected to disclosure only in confidence.<sup>49</sup>

Again, in point, is the Restatement comment that "Matters which are completely disclosed by the goods which one markets cannot be a secret."<sup>50</sup> One cannot escape the conclusion that the ability to duplicate by inspection and analysis depends to a degree on the competency and resources of the inspector. Thus, the fact that a machine was exposed to public view in a small machine shop, but was not seen by one technically competent to evaluate its structure, did not constitute a disclosure which would vitiate the element of secrecy.<sup>51</sup> However, when one considers the vast resources available to the Government if it should elect to duplicate independently a market product, coupled with the strong public interest obligation of the Government to competitively procure, the reverse engineering test reasonably applied is neither inconsistent with law, against public policy, or in contravention of its announced policy to give due recognition to proprietary rights in data. In determining whether information is, or is not, readily or reasonably disclosed by inspection and analysis, consideration should be given to the cost and time which would be expended in the effort.

The ASPR definition, in short, sought to capture in simple and capsule form the basic elements of the trade secret, citing for illustrative purposes typical examples, and at the same time sought to include qualifying statements which were consistent with the law on the subject and the procurement policy objectives of the Department. The drafters considered the definition compatible with the policy of honoring proprietary rights in data.

Having explored the common law definition of a trade secret and its relation to the ASPR definition of proprietary data, there remains for consideration the principal objective of this article—the suitability of using "proprietary data" in contracts, as prescribed by the Regulation.

### V. CONTRACT DATA REQUIREMENTS

Contract data requirements are not established on the basis of whether the data is proprietary or non-proprietary. Contracts

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<sup>49</sup> 1960 Hearings at 122 (Testimony of Mr. G. C. Bannerman): "There is some difference of opinion between DOD and industry on what the term proprietary data should include. Industry would describe as proprietary data any information it desired to protect rather than limiting the term to trade secrets. We cannot agree with industry that we should by regulation extend protection to information which is in the public domain or which can be readily obtained by analysis and examination of the product, and, hence, which can be readily copied by others."

<sup>50</sup> Note 25 *supra*.

<sup>51</sup> *Newell v. O. A. Newton Co.*, *supra* note 24.

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may call for complete sets (or lesser requirements) of data for mission purposes<sup>52</sup> or may establish requirements for engineering or design data to meet specified "intended uses."<sup>53</sup> The detail and form in which data must be furnished are spelled out, for example, in the case of engineering data requirements in the Air Force, in ten referenced specifications,<sup>54</sup> which include the basic Department of Defense data specification MIL-D-70327. Since, in the absence of special provisions governing the furnishing of proprietary data, the various tables and specifications are so sweeping in their engineering data and drawing requirements that proprietary data could be called for in every case, a number of special provisions are prescribed by **ASPR** which are controlling in respect of proprietary data regardless of any of the other contract requirements. Thus, there is required to be included in supply contracts a "fail-safe" provision which provides that "Notwithstanding any Tables or Specification included or incorporated in the contract by reference, proprietary data need not be furnished unless suitably identified in the Schedule of the Contract as being **required**."<sup>55</sup> The provision then sets forth the **ASPR** definition of proprietary data. In the case of a contract which has, as one of its principal purposes, experimental, developmental or research work, the prescribed clause provides that the contractor need not furnish proprietary data for items developed at private expense and previously sold or offered for sale, including minor modifications thereof, which are incorporated as component parts in or to be used with the product or products being developed. In lieu thereof, the contractor identifies such items and

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<sup>52</sup> U.S. Dep't of Air Force, MCP Form No. 71-77, Issue II (Aug. 1960), p. 9, fig. II. Mission purposes are Manufacture (competitive procurement), Design modification, Manufacture (Government), Service testing, Item of design evaluation, Production inspection, Receiving inspection, Overhaul, Installation, etc.

<sup>53</sup> See SECNAV Instruction 4120.12, in *Hearings on Sole Source Procurement Before the Subcommittee for Special Investigations of the House Committee on Armed Services*, 87th Cong., 1st Sess. 303 (1961), which lists principal uses of data as:

- (a) Approval and evaluation;
- (b) Quality assurance (including inspection);
- (c) Installation, operation, maintenance, or repair and overhaul;
- (d) Emergency manufacture for repair and overhaul;
- (e) Development of performance specifications;
- (f) Development of component parts specifications;
- (g) Design and interchangeability control;
- (h) Provisioning; and
- (i) Procurement or manufacture of items and parts for stock, repair, or replacement.

<sup>54</sup> U.S. Dep't of Air Force, MCP Form No. 71-77, Issue II (Aug. 1960), p. 1.

<sup>55</sup> **ASPR** 9-203.2 (Feb. 15, 1962).

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the proprietary data pertaining thereto which is necessary to enable reproduction or manufacture of the item.<sup>56</sup> In the latter provision as well, the ASPR definition of proprietary data is included. A third special provision<sup>57</sup> is prescribed for negotiated contracts for supplies calling for proprietary data which are to be obtained subject to limitation on use. Such limitation precludes use for reprocurment. In the latter case the schedule of the contract must state the extent of the proprietary data to be furnished subject to such limitations.

From the foregoing recital it is apparent that the delineation and designation of proprietary data is important in the negotiation of supply contracts. The omission or delivery of proprietary data, either subject to limitation on use, or otherwise, depending on the contract terms is, of course, significant in assessing contract performance.

In summary, satisfying the functional needs of the Government for data is the principal procurement objective. Whether the data is or is not proprietary is a complicating factor in pricing data and obtaining rights therein.

### VI. CONTRACT DATA PROBLEMS

#### A. IDENTIFYING PROPRIETARY DATA IN CONTRACT

In the case of many newly developed weapons and weapon systems, engineering or design data, including data covering processes of manufacture, may not even be in existence at the time of the negotiation or, if in existence, it may not be possible to know or to evaluate whether such existing data in the possession of the prime or its potential sub-contractors will qualify as proprietary data. If negotiating as to such existing data is baffling, certainly as to nonexisting data the problem of designating in the contract schedule what data is proprietary, whether such data is to be delivered, with or without limitation as to use, is even more perplexing. Consider further, the problems arising in the course of contract performance where, for example, in the case of a major aircraft contract, the contractor may be required by its terms to furnish over a million drawings. The "flexible" factors discussed above apply to each drawing, whether it originates with the prime contractor, a subcontractor or vendor. If the "fail-safe" provision applies, proprietary data may be omitted; if furnished for limited use, they will be stamped by the contractor with the appropriate restrictive legend. In either event the contractor (or

<sup>56</sup> ASPR 9-203.4 (Feb. 15, 1962).

<sup>57</sup> ASPR 9-202.2(b) (1) (Feb. 15, 1962).

his subcontractor or vendor) makes the initial, and undoubtedly in most instances, the final judgment. The Government has the formidable task of evaluating that which is omitted, in the absence of the evidence, or where submitted subject to limitation as to use, of applying the flexible factors to determine if the data so stamped is in fact proprietary. Obviously this can only be done, at best, on a spot check basis. Even so, it requires the services of qualified engineers and attorneys. In all likelihood any omission or improper marking will not be detected until the data is requisitioned for some "intended use." It would consume an inordinate amount of manpower and time to completely and thoroughly examine and evaluate such drawings before acceptance.

In an article by Howard I. Forman,<sup>58</sup> who at one time served as head of a patents group for a field agency of the Department of the Army, there is presented a graphic three-year case history of the complex problems which arose in the negotiation and performance of a research and development contract of the Army Ordnance Corps where the contractor sought to safeguard from later commercial use by others his proprietary rights in background information and data which were required to be furnished to the Government. It dwells on the negotiation but also discusses the contract administration problems with respect to restrictive legends placed on the drawings furnished. In the case in question the Government project engineer did, in fact, review the progress reports of the contractor and restrictive legends thereon indicating that certain data was proprietary. He consulted with patent counsel who could see nothing in the alleged proprietary information that wasn't to be found in normal reference handbooks. The company reviewed the matter and admitted its error and asked that the copies of the report be returned for reconsideration. When the report was returned it was observed that the restrictive markings as to some fifty items which had been alleged to be proprietary in the first issue were removed, but approximately the same number of other items were alleged to be proprietary in the second issue. "However, despite the fact that not one word of the report itself had been changed, not a single item of the first group was included among those listed in the second group."<sup>59</sup> This raised serious doubts as to whether there was any agreement among the corporation's engineers as to what was really proprietary data. The Government met with the con-

<sup>58</sup> Forman, *Proprietary Rights in Research and Development Contracting—A Case Study*, 17 Fed. B.J. 298 (1957).

<sup>59</sup> *Id.* at 308.

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tractor's officials and at this meeting "it was agreed by both sides that it was a practical impossibility to comply with the controversial clause . . . because there were too many differences of opinion among the contractor's personnel, as well as among the Government's personnel as to what constituted 'proprietary data.'"<sup>60</sup> The company finally agreed to reissue its reports without any markings on them whatsoever.

### B. INDUSTRY VIEWS ON PROPRIETARY DATA

Superimposed on the difficulties described are additional problems posed by the magic words "proprietary data." Regardless of the Regulation and contract clauses, segments of industry neither understand or accept the ASPR definition nor, for that matter, the common law concept of trade secrets. In such cases, even a common meeting ground for negotiation on the subject is lacking.

It has been previously noted that in the course of the hearings before the Multer Subcommittee, industry witnesses repeatedly took the Department of Defense to task for the inadequacy of its definition of proprietary data, particularly with respect to the matter of reverse engineering.<sup>61</sup> An opportunity was afforded these witnesses to present their views in writing. In a lengthy letter to Chairman Multer, dated June 23, 1960, from three of the principal witnesses, Messrs. Scott, Marschalk, and Lent,<sup>62</sup> there is a very extended dissertation on the subject of the ASPR definition, but most significant is the following explanation of what "industry"<sup>63</sup> considers should be treated as "proprietary :"

<sup>60</sup> *Ibid.*

<sup>61</sup> 1960 Hearings at 27, 30, 34, 52, 69, 109.

<sup>62</sup> 1960 Hearings at 215.

<sup>63</sup> One of the frustrating aspects of the proprietary data problem is the fact that the Government must contend with divergent views of industry. It is most misleading to characterize any position in this matter as an industry position. In testifying before the Multer Subcommittee, Philip McCallum, Administrator, Small Business Administration, aptly summarized this situation as follows:

"Any review of the effect of the Department of Defense policies governing proprietary rights and data immediately discloses that the small business community is not of a single mind in these matters. The opinion of an individual concern is tempered, obviously, by its interest in and relation to defense procurement. A prime contractor may have one view; a subcontractor, another. A practice which benefits one firm may be an anathema to another.

"A firm which looks primarily or exclusively to defense production for its business may encounter difficulties under the military programs which are different from those of a concern which is engaged primarily in nondefense activities and which accepts defense contracts if, as, and when it is convenient and to its advantage to perform them.

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Industry's position is simple and clear: These drawings are the private property of the private parties who spent the time and the money to create them. This is true regardless of the information they contain. Like any other private property, the owner can dispose of these drawings in any legal manner he chooses. He can give them away, sell them, loan them, or release them for stipulated purposes, only. Their value cannot be measured in terms of the paper, ink and time required for physically preparing them; their true value resides in the information or data thereon, and the rights to use that data to convey the intelligence which it represents. The right to use the drawings to convey the intelligence reflected by them is the primary right of ownership.

A good illustration can be obtained by carrying the point to the ridiculous. Suppose that a manufacturer of valves is foolish enough to spend his time and money to create a drawing for a standard and commonplace 10-32 machine screw. He assigns his own part number and uses his own title block. The manufacturer owns that drawing. He does not own any rights so far as 10-32 screws are concerned. If the Government wants the manufacturer's drawing, it must get it under the terms of use agreed to by the manufacturer. This in no way stops the Government from getting all the 10-32 screws it wants from countless sources, but it has no right to use this manufacturer's drawing of a 10-32 screw to manufacture them unless the manufacturer has agreed to release the drawing for that purpose.

Is this position reasonable? Indeed it is. The knowledge of the production of 10-32 screws is in the public domain and, therefore, it can be obtained from the public domain and the Government's position in respect to getting competition for the production of 10-32 screws is completely protected. To contend that because the information is in public [sic] domain, the manufacturer's rights in his drawing need not be respected, is to introduce a factor of judgment to which the manufacturer is not a party. When the Government assumes the arbitrary right to decide what part of a manufacturer's drawing is, or is not, proprietary, a dividing line of justice can no longer be drawn.<sup>64</sup>

The above typifies the views of a very vocal segment of industry. The point is made that "regardless of the information it contains" the drawings of a manufacturer are his private property and should be respected even if the information is in the public

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"There are many small concerns whose principal source of income is derived from the sale of proprietary items. To them any regulation which makes proprietary data available to competitors is undesirable.

"On the other hand, there are many small concerns which do not sell proprietary items. . . .

"These firms, too, are extremely important to the Nation's economic strength and to its defense program. If their opportunity to participate in defense procurement is seriously curtailed, the present decline in the participation by small business in the defense program will be accelerated. . . .

"It is obvious that comments on present proprietary policies or recommendations for change must be viewed in the light of the experience and interests of the firm making this criticism or recommendation; and we can appreciate their position. However, consideration must be given to the needs of every type of defense contractor." 1960 Hearings at 122-23.

<sup>64</sup> 1960 Hearings at 215.

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domain. That a drawing produced by one is his private property is unquestioned: that he has a right to sell it or withhold it, is likewise true; but the mere fact that it is private property does not endow the information contained therein with the attributes of, or entitle it to the protection accorded, a trade secret.

The foregoing is cited because it fairly reflects the views of some who contract with the Department of Defense, and who may well be applying such criteria in negotiating and marking proprietary data.

To protect itself against improper markings the Department of Defense reserves the right, notwithstanding any provisions of the contract concerning inspection and acceptance, to modify, remove, obliterate, or ignore any marking not authorized by the terms of the contract on any piece of data furnished under the contract.<sup>65</sup> While it is argued that this vests in the Department an arbitrary right to destroy valuable rights in the contractor, the fact is that the Government is most reluctant to exercise such authority. It is probable that it would be done only in the clearest cases. Errors in judgment invite censure and litigation.

Even the General Accounting Office, which is most solicitous of the Government's rights, which champions procurement by formal advertising, and which has criticized Government agencies for failing to procure and use available data for competitive procurement,"" adopts a most cautious and conservative approach in passing upon complaints that proprietary data is being improperly used for reprourement, as evidence by the cases discussed below.

### C. DATA DISPUTES

The experience of the Air Force in two instances in which it sought to utilize data for reprourement, in furtherance of what was considered to be the will of the Congress, the recommendations of the Comptroller General and the policy of the Department of Defense to assure "optimum competition in the purchase of military supplies" will illustrate the perplexing problems and frustrations confronting the beleaguered bureaucrat at the working level. In discussing these cases it is not intended to embark on a critique of the factual and legal considerations of the cases in question but rather to present a resume of the chronology of events so as to give some indication of the legal complexities and,

<sup>65</sup> ASPR 9-203.1(h) (Feb. 15, 1962).

<sup>66</sup> Report of Comptroller General to Congress, in *Hearings on Sole Source Procurement*, supra note 53, at 871; Testimony of the Comptroller General (Joseph Campbell), *Hearings*, supra, at 11.

more significantly, of the procurement delays incident to the resolution of this type of dispute.

*Gayston-Dayton Aircraft Case.* One case involved the procurement of a nylon static discharger in which an exhibit attached to the specification utilized by the procuring agency, an Air Force Depot, for inviting bids pursuant to formal advertising, had been furnished to the Air Force by the Gayston Corporation. When the bids were opened on August 4, 1960, another firm, Dayton Aircraft Products, Inc., was the low bidder. The Gayston Corporation, which had initially submitted an unsolicited proposal containing improvements to static dischargers to an Air Force laboratory for test and evaluation purposes and which had subsequently drafted the exhibit to the specification in order to interest the Air Force procuring agency in purchasing the improved product, protested to the Air Force and the Comptroller General that the exhibit it had prepared was proprietary to it and was improperly used for competitive procurement. The Air Force position supporting its rights to use the exhibit prepared by the Gayston Corporation was submitted to the Comptroller General on November 8, 1960. There followed a series of decisions by the Comptroller General. In the first, on December 22, 1960, he ruled in favor of the Gayston Corporation on the apparent grounds that the specification was **proprietary**.<sup>67</sup> When the award was about to be made, the low bidder, Dayton Aircraft Products, Inc., in turn, protested. The second decision was rendered by the Comptroller General on May 15, 1961,<sup>68</sup> affirming his earlier ruling. On a reclama by Dayton Aircraft Products, Inc., the Comptroller General again reviewed the case and on June 21, 1961, reaffirmed his earlier holdings.<sup>69</sup> In so doing he recognized by reason of information supplied by Dayton Aircraft Products, Inc., that the exhibit prepared by Gayston "may not have fallen within the strict definition of a 'trade secret' as enunciated in Section 757(b), Restatement of the Law of Torts," but found that it had been received in confidence, presumably without regard to whether it was a trade secret, and the Government was under a duty 'to hold its details inviolate.'<sup>70</sup> The contract was finally awarded to the Gayston Corporation on June 29, 1961, almost eleven months from the date of the original protest. In the meanwhile the procurement was delayed in the Air Force despite urgent defense requirements. To have given the contract to the Gayston Cororation

<sup>67</sup> Ms. Comp. Gen. B-143711 (Dec. 22, 1960) (unpublished).

<sup>68</sup> Ms. Comp. Gen. B-143711 (May 15, 1961) (unpublished).

<sup>69</sup> Ms. Comp. Gen. B-143711 (June 21, 1961) (unpublished).

<sup>70</sup> *Id.* at pp. 1-2.

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during the period that the protest was under review would have rewarded the protestant by awarding it a contract at a higher price by virtue of the fact that its protest had put the matter in issue; while an award to Dayton Aircraft Products, Inc., before the final disposition of the issue might have inequitably prejudiced the Gayston Corporation, if its position were later supported, and left it with a questionable remedy. The views of the Comptroller General as to the latter consideration were expressed as follows in its December 22, 1960, decision:

We are of the view that an award under the instant invitation would not be "most advantageous to the United States" under the circumstances involved. Any resulting contract to the low bidder would embody specifications which were not rightfully the property of the Government and would unreasonably compound the injury already suffered by Gayston. Also we do not believe that the Government should infringe a proprietary right by competitive procurement. It should be noted that Gayston has no readily available statutory remedy to pursue as would be the case where a patent is being infringed under a Government contract. . . . While Dayton Aircraft is the lowest bidder under the invitation and would be ordinarily entitled to an award, we believe that the integrity of the Government as a contractor requires that the invitation be canceled."

*Aircraftsmen Case.* The case of the protest of Aircraftsmen, Inc. is equally in point. The facts are briefly as follows :

Aircraftsmen, Inc. furnished drawings to the Air Force covering an empennage stand procured by the Air Force under a negotiated contract in August, 1956. The Air Force subsequently sought to use these drawings for procuring empennage stands on a formally advertised basis commencing in April, 1960. After a number of delays the opening of bids was finally scheduled for November 7, 1960. In the meanwhile Aircraftsmen, Inc., had protested to the Air Force that an award to any other firm would result in a patent infringement and also brought the matter to the attention of the Senate Small Business Committee. Informal meetings were held with the committee staff and by letter of October 14, 1960, the Air Force stated its position to the effect that the Department had full rights to the drawings in question and that it proposed to proceed with the procurement as scheduled. Aircraftsmen then protested to the Comptroller General on November 4, 1960. Further procurement action was held in abeyance and, at the request of the Comptroller General, the Air Force again reviewed the case and responded to the Government Accounting Office (GAO) on February 16, 1961, affirming its position that the Air Force had full rights in the data. The Comptroller General, after exhaustive consideration of all the facts,

<sup>71</sup> Ms. Comp. Gen. B-143711, *supra* note 67, at p. 6.

including the study of affidavits submitted by the company and the Air Force, came to the conclusion "that the Government did not obtain under Contract No. **33670** a license or right to use the Aircraftmen empennage stand data and drawing No. 1001 for competitive procurement purposes and that by necessary implication the Government agreed that it would not so use such data and drawing." His decision was rendered on August **28, 1961**.<sup>72</sup> Ten months had elapsed before the matter was administratively resolved.

While it is not proposed to indulge in a critique of the GAO decision, it is submitted that a careful study of the opinion will convince the reader that a considerable effort was made to reach what was undoubtedly regarded as an "equitable" result. The case highlights again the difficulties in determining the Government's legal rights to data encountered both by the Air Force and, judging from the time devoted to its review before reaching a final decision, by the GAO. This factual analysis also demonstrates the adverse impact on procurement of the inevitable delays involved in the final resolution of such disputes.

It has been argued that there are other "flexible" yardsticks in Government contracts which give rise to disputes, the most noteworthy of which is the provision in a number of standard clauses for "equitable adjustment" of the contract price, and that the Government and its contractors have been able to cope with such disputes without adversely affecting the procurement process. There are, however, significant differences. For example, the equitable price adjustment is predicated on generally accepted accounting principles-codified for the Department of Defense in the ASPR, Section XV. These principles are well defined and universally accepted. More importantly, disputes as to "equitable adjustment" of price do not delay contract performance. The contractor is obliged to proceed with the contract work during such period of negotiated price adjustment, or during an appeal in the event of a dispute. In the case of data, however, the Department is reluctant to ignore markings or even to appropriate for procurement unmarked drawings which are the subject of proprietary rights claims until the matter has been fully resolved. An equitable price adjustment may be rectified by an appeal, but an improper publication of proprietary data has lasting and perhaps costly consequences. The publication can destroy the secrecy.

As a result of the unique nature of proprietary data and information and the possibly irretrievable consequences which flow from compromising the element of secrecy through improper dis-

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<sup>72</sup> 41 Comp. Gen. 151 (1961).

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closure, disputes with respect to proprietary rights in data tend to forestall usage until the matter is resolved with some degree of certainty.

Time is of the essence in defense procurement. The protracted delays which may be involved in the adjudication of the question as to whether data is proprietary or not for the purpose of use of such data for reprourement cannot be tolerated. Neither the Board of Contract Appeals procedure nor GAO review provide an adequate vehicle for the resolution of disputed data issues under such circumstances.

In summary, therefore, the indefiniteness of the proprietary data definition and the resultant problems to which it gives rise in contract administration, compounded as they are by industry's non-acceptance of the ASPR definition and the serious consequences to procurement of the delays incident to the resolution of disputes with respect to the identification, furnishing and subsequent usage of data alleged to be proprietary, all contribute to the difficulties and deficiencies encountered in trying to carry out the provisions of the current Regulation.

The Department of Defense is, of course, fully aware of these problems. Mr. Bannerman, Director for Procurement Policy, Office of the Assistant Secretary of Defense (Supply and Logistics) testified at length on the subject before the Multer Subcommittee in March, 1960.<sup>73</sup>

### VII. DOD PROPOSAL—"DATA DEVELOPED AT PRIVATE EXPENSE"

Recognizing that a fresh approach was necessary to correlate more effectively and practicably the interests of the Government in obtaining all data essential to meet its requirements and at the same time in carrying out the Government's policy of fostering private development of items having military usefulness and encouraging free flow of information concerning such items to the Government, a revised draft of the Regulation was developed by the Department of Defense and presented to industry in November, 1960. The basic policy was to provide protection for data developed at private expense. The following extract from the letter explaining the revised Regulation presents the rationale underlying the new concept :

It was concluded that any definition of "proprietary data" which would be objective and susceptible of reasonable administration would necessarily be so broad as to be valueless. For instance, all would agree that such a

<sup>73</sup> 1960 Hearings at 121-142.

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definition should include data concerning "treatment of materials," "manufacturing methods," "chemical composition,") etc., since information on these matters is not readily ascertainable from the product. But, how about "tolerances" and basically, how about "designs"? These also are frequently not readily ascertainable from the product although admittedly they frequently are. Hence, if the test of "readily ascertainable from the product" is retained, we are immediately thrown back into the necessity for a controversial, item-by-item determination in advance of contracting and, in some cases, in advance of design and development. This procedure has already been found to contain formidable administrative difficulties. It has been suggested that, in order to make our administration feasible, we should eliminate the test of "readily ascertainable from the product" and treat all data on tolerances and designs as "proprietary." Such a policy would render practically all manufacturing drawings "proprietary" since practically all drawings contain information concerning designs or tolerances.

We have concluded that the only practical solution is to eliminate the definition of "proprietary data" altogether and to provide "limited rights" protection to data which was developed at private expense. This conclusion greatly simplifies both the regulation and its administration. It permits us to get any and all data which we need and eliminates the necessity for pre-decision as to the "proprietary" nature of individual items of data. . . .

Meetings held with industry representatives in December, 1960, and in July, 1961, failed to achieve any accord or acceptance of the new proposal. To those knowledgeable in Government procurement, the problems anticipated in the substitution of "data developed at private expense" for "proprietary data" were not as formidable perhaps as those presented by "proprietary data" but were sufficient to arouse deep concern that the substitution might only be replacing one set of problems with another. The proposal is still in abeyance.

## VIII. RECOMMENDED SOLUTION

It is apparent that there is no simple solution to the data problem. There is no assurance that substitution of the concept of "data developed at private expense" for that of proprietary data will achieve practical results. Whatever terminology is employed, the value of data or information is not to be determined by the label it bears. Not only are many factors determinative of the value of data or information, but also there can be a great variance in opinion as to the assessment of such factors. In one case the amount invested in the development of the information or data may be controlling; in another the benefits to be derived by the prospective buyer may **fix** the price. The mere fact that information may be novel or secret does not necessarily endow it with great value. However, the fact that it is an innovation, a discovery, or perhaps an invention which represents a great tech-

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nological advance or breakthrough in the art or will result in greatly expedited or more economic production would provide the basis for substantial reward. The reward is not necessarily a payment. More often than not it may be the award of a research and development or hardware contract.

No doubt Government personnel have been too prone at times to negotiate for proprietary data or information on the basis of actual cost plus an allowance for overhead and profit and without regard to its other characteristics of value. They may have failed to recognize the significance of such values in demanding such data or information with unlimited rights of use as an incident to contract award without payment therefor. Finally, notwithstanding its intrinsic commercial value to the contractor as a trade secret, they may have demanded such data needlessly. It is submitted that the most realistic way to cope with the problem is to follow the procedures established generally by the Armed Services Procurement Regulation with respect to pricing. This would be accomplished by a statement of data policy with such additional direction as may be necessary to impress on procurement personnel that proprietary data or data developed by the contractor at his own expense may have an intrinsic commercial or market value which must be accorded full consideration both in the establishment of contract data requirements and in connection with negotiating for the end item for which such information or data is to be provided.

The requirements for data would be incorporated in the schedule in terms of "mission objectives" or "intended uses" with any other descriptive material (military specifications) essential to establish the detailed manner and form in which the material is to be prepared and furnished, without regard to any further characterization as to whether such data is "proprietary" or "developed by the contractor at its own expense." The price to be paid will, however, be determined by the nature of the data and whether it is to be procured for unlimited use, including manufacture or procurement, or whether it is to be obtained subject to usage limitation. The contract implementation therefor would be substantially in the form of the two standard type clauses which cover the furnishing of data, one without limitation as to use and the other with restriction as to use as provided in the schedule.

The foregoing, of course, represents merely the underlying principle for such implementation. It does not seek to deal with more detailed considerations, or delve into the problems of subcontractor, or so-called "vendor data." This would require further development. Admittedly, it is not a novel solution. It repre-

sents a compromise between the past and the present. Prior to the publication of the Regulation, there was a policy vacuum, in that no guidance or instruction was given to procurement personnel in this area. With the introduction of the current Regulation not only was the stage set for according recognition to proprietary data but the script provided a detailed and intricate contractual mechanism for carrying out the policy in all phases of procurement, and, as a result, gave rise to the problems discussed above. The proposal that recognition of such data be accorded in the Regulation through appropriate pricing philosophy or by acceptance subject to limitation as to use, but not through a provision in the contract itself, represents a middle of the road approach and one which may well achieve the mutual objectives sought by Government and industry.

There will still remain a divergence of views at the bargaining table as to the value of proprietary data which may be considered part of the data package called for under the contract, or as to the identification of data which is to be provided subject to limitation as to use, including data to be supplied by subcontractors or vendors or of data which need not be furnished. However, such difference of opinion will be resolved, as they should be, prior to execution of the contract—and not perpetuated during its administration and even for years following its completion. There will still be the problem of avoiding at the outset what has been commonly referred to as “swiss cheese drawings”; *i.e.*, those drawings in which the proprietary data is omitted or blocked out with the result that the Government is provided with emasculated drawings that may not even be suitable for maintenance or in-house repairs. Finally, there will also be data problems associated with contract performance, such as determinations as to the adequacy or completeness of data supplied pursuant to contract schedule requirements and specifications. Whatever these residual problems may be, considerable progress will have been made if “proprietary rights” questions can be eliminated from the area of contract performance and data delivery evaluation.



## COMMENTS

**THE UNEASY CASE FOR PROHIBITING TELEGRAPHIC BIDS.\*** As a general rule, telegraphic bids are not authorized in formally advertised Government procurement.' Unauthorized telegraphic bids are treated as unresponsive to the invitation for bids and are not considered for award of a contract.' A contracting officer may permit telegraphic bids when the date for bid opening is too close for bidders to prepare and submit bids on the required forms or when prices are subject to frequent change.:<sup>1</sup> In contrast to the restrictions on wired bids, telegraphic modifications of hand-delivered and mailed bids are always authorized,<sup>2</sup> subject to the rules governing late modifications.: The general prohibition of telegraphic bids seems unjustifiable, particularly when compared with the treatment accorded telegraphic modifications.

Nearly a decade ago the Comptroller General indicated that the justification for prohibiting telegraphic bids was the possibility that a bidder could wire his bid after learning from the public bid opening what the other bids were." That possibility, however,

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\* The opinions and conclusions presented herein are those of the author and do not necessarily represent the views of The Judge Advocate General's School nor any other governmental agency.

<sup>1</sup> Armed Services Procurement Reg. para. 2-202.2 (April 15, 1962) (hereinafter referred to and cited as ASPR); Federal Procurement Reg. para. 1-2.202-2 (1960) (hereinafter referred to and cited as FPR); Standard Forms 30 and 33 (Oct. 1957 ed.), cl. 2(a).

<sup>2</sup> 40 Comp. Gen. 279 (1960), digested in U.S. Dep't of Army, Pamphlet No. 715-50-72, § II, para. 2 (1961) (Procurement Legal Service) (hereinafter cited as DA Pam 715-50-72). General rules on the responsiveness of bids are contained in ASPR 2-404.2 (Oct. 3, 1960) and FPR 1-2.404-2 (1960).

<sup>3</sup> ASPR 2-202.2 (April 15, 1962); FPR 1-2.202-2 (1960).

<sup>4</sup> ASPR 2-304(a) (April 15, 1962); FPR 1-2.304 (1960); Standard Forms 30 and 33 (Oct. 1957 ed.), cl. 2(a).

<sup>5</sup> ASPR 2-305 (April 15, 1962); FPR 1-2.305 (1960); 35 Comp. Gen. 468 (1956), digested in DA Pam 715-50-1, Bids and Awards para. 66 (1957).

<sup>6</sup> Ms. Comp. Gen. B-116567 (Aug. 26, 1953), digested in 22 U.S.L. Week 2093 (1953). The Comptroller General adopted as the reason for the prohibition the position of the Court of Claims in *Leitman v. United States*, 104 Ct. Cl. 324 (1945). The Comptroller General permitted consideration of a wired bid that had been dispatched before bid opening. The Comptroller General argued that the person sending the telegram could not have had knowledge of the other bids. The decision was overruled by 40 Comp. Gen. 269 (1960), digested in DA Pam 715-50-72, § II, para. 2 (1961), but the overruling pertained only to the permission to waive the failure to obey the prohibition against wired bids.

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is eliminated by the rule prohibiting consideration of any bid, whether mailed or telegraphed, that is received after bid opening and was not deposited for transmission in time for delivery before the bid opening.; Proof of timely filing, however, may be more difficult for a wired bid than for a mailed one. For example, there is nothing for telegrams comparable to the fixed railroad and airline dispatch schedules maintained for letters. The additional burden, though, will fall not so much on contracting officers as on persons choosing to wire bids. A late telegraphic bid will not be considered by the Government unless the bidder provides clear and convincing evidence, including substantiation by an official of the telegraph company, that the bid was timely filed.<sup>8</sup> Evaluating proof may be slightly more difficult for a contracting officer when a late bid was wired rather than mailed. However, the additional difficulty must also attend late telegraphic modifications, and they are not prohibited.

It might be contended that increased use of telegrams would increase the number of late bids, and thus the administrative problems of contracting officers, as bidders exercise a natural propensity to wait until the last minute before depositing bids. That propensity, though, must operate even when telegraphic bids are not allowed, and there is no reason to believe there would be more late telegraphic bids than late mailed bids or telegraphic modifications.

The argument may be made that telegraphic bids are restricted because valid contracts cannot be made by telegrams. However, the usual rule appears to be that contracts may be made by wire." Moreover, if the argument were true, neither telegraphic bids nor telegraphic modifications would ever be permitted.

A more respectable argument is that proving that a bid was submitted with the bidder's authorization is more difficult for telegraphic than for mailed bids. The burden of proof falls on the Government when an attempt is made to bind a low bidder who claims a bid in his name was not authorized. The argument, nonetheless, has apparently been thought insufficient to justify prohibiting telegraphic modifications. There seems to be no reason why it should be more persuasive where telegraphic bids are involved.

It may be contended that the reason for prohibiting telegraphic bids is a simple administrative one: if bids are submitted on

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<sup>7</sup> ASPR 2-303 (April 15, 1962); FPR 1-2.303 (1960); Standard Forms 30 and 33 (Oct. 1957 ed.), cl. 4.

<sup>8</sup> ASPR 2-303.4 (April 15, 1962); FPR 1-2.303-4 (1960).

<sup>9</sup> 1 Corbin, Contracts § 36, 78, 81 (1960).

forms identical in size and shape, the contracting officer's burden of working with the bids is eased. The answer is that bidders are free to use any document—other than a telegram—regardless of size and **shape**.<sup>10</sup> Besides, the present rules increase the contracting officer's burden. They force bidders who wish to submit a price at the last minute to mail a formal bid followed by one or several telegraphic modifications. Thus the contracting officer has two or more communications instead of the one he would have if telegraphic bids were permitted.”

It appears from the foregoing that the justification, if any, for restricting telegraphic bids must differentiate between those bids and telegraphic modifications. One possibility is that modifications are relatively simple, while bids are complex—particularly with the required contract clauses and specifications—and cannot be conveniently contained in a telegram. However, the incorporation by reference technique, now permitted when telegraphic bids are **authorized**,<sup>12</sup> should make a telegraphic bid a simple document.

Another possibility is that telegraphic bids are usually prohibited because they cannot comply with requirements for descriptive **literature**<sup>13</sup> or bid bonds.“ Wired modifications only rarely involve changes in descriptive literature or bid bonds.” However, the suggested justification applies only when bid bonds or descriptive literature are required ;the prohibition sought to be justified is far more sweeping. Moreover, when bid bonds or descriptive literature are required, they impose constraints of their own on the use of telegrams. It is not clear why additional constraints should be imposed by the Government when means

<sup>10</sup> See Ms. Comp. Gen. **B-128399** (July 19, 1956), digested in DA Pam 715-60-1, Bids and Awards para. 69 (1957). See also ASPR 2-301(c) (April 15, 1962); FPR 1-2.301(c) (1960).

<sup>11</sup> The regulations provide that “In order that the contract may be executed on the proper forms the invitation for bids will also provide that telegraphic bids shall be confirmed on the prescribed form and submitted promptly to the contracting officer.” ASPR 2-202.2 (April 15, 1962); FPR 1-2.202-2 (1960). It is not clear whether all telegraphed bids, or only the winning one, need be confirmed. Even if all must be confirmed, the forms for each one but the winning bid would only be stored and would not prove administratively burdensome.

<sup>12</sup> ASPR 2-202.2 (April 15, 1962); FPR 1-2.202-2 (1960).

<sup>13</sup> See ASPR 2-202.5 (April 15, 1962); FPR 1-2.202-5 (1960).

<sup>14</sup> See ASPR 10-102 (Jan. 31, 1961); FPR 1-10.102 (1961).

<sup>15</sup> Most modifications change prices or delivery dates. Occasionally a modification increasing the bid price might require a change in the bid bond. There seems to be no reason why the bondsman could not telegraph an increase in the bid bond. See 39 Comp. Gen. 619 (1960), digested in DA Pam 715-50-64, § 111, para. 4 (1960). Moreover, the penal **sum** of bid bonds is frequently expressed in terms of a percentage of the bid price. See ASPR 10-102.3(b) (Jan. 31, 1961); FPR 1-10.102-3(b) (1961). Such bonds would not require a change even when a modification increases the bid price.

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are devised for overcoming the constraints inherent in the requirement of bid bonds and descriptive literature. For example, descriptive literature may be mailed or hand-delivered early, because it involves no last-minute calculation. Prices, delivery dates, and similar dates could then be telegraphed at the last minute, and there seems to be no cause for prohibiting use of a telegram.<sup>16</sup>

It may be argued that telegraphic bids are restricted because they are less secret than mailed bids. Wired bids may be compromised by either the telegraphic agency or by the Government official who opens a telegram so that the invitation number and the bidder's name may be put on the bid envelope.<sup>17</sup> Secrecy is much less a problem with modifications, which usually contain a statement, such as "Deduct \$10,000 from price of item 1," that would be of little help to competing bidders. Telegraphic bids are not unique in their susceptibility to compromise. Mailed bids may be opened by the Government to identify the bidder and the procurement.<sup>18</sup> Moreover, a person using a wired bid may send a supplementary telegram instructing the telegraph clerk at the receiving end about putting the bidder's name and the invitation number on the bid envelope. The telegraph agency could leak information to a competing bidder. Yet the possibility of a leak is probably rather small. In any event, secrecy is enforced for the bidder's protection, and he should be permitted to risk disclosure as the price of using a telegraphic bid.

The suggestion may be made that telegraphic bids and modifications are treated differently because only the former are so complex that errors in transmission will be frequent. Even though incorporation by reference simplifies bids, they will be much more complex than modifications and thus the chances for errors increase. Each error may require expensive and time-consuming handling before a bidder may obtain appropriate relief.<sup>19</sup> Thus there is a forceful argument for permitting wired modifications and prohibiting wired bids. The counter-argument is that tele-

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<sup>16</sup> Bid bonds also may be mailed early. As explained in note 15, *supra*, the penal sum of bid bonds is frequently stated not as a specific sum but only as a percentage of the bid price. Thus a bond may be issued before a bid price is established. If the bondsman insists on expressing the penal sum as an exact figure, the bidder may set a figure certain not to be lower than the final bid will be.

<sup>17</sup> According to the regulations, "Unidentified bids may be opened solely for the purpose of identification, and then only by an official specifically designated for this purpose by the head of the purchasing activity." ASPR 2-401(b) (July 1, 1960); FPR 1-2.401(b) (1960).

<sup>18</sup> See the regulations quoted in note 17, *supra*.

<sup>19</sup> The correction of mistakes is treated in ASPR 2-406 (dated variously July 1, 1960, Jan. 31, 1961, Aug. 21, 1961, Feb. 15, 1962) and FPR 1-2.406 (dated variously Sept. 1960 and Sept. 1961).

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graphic bids are not unique in their susceptibility to errors. A bidder may, for example, telephone his bid from City A to an agent in City B who records figures on a bid form which is then hand-delivered. The means of transmission is at least as subject to error as is telegraphy; yet the bid may be considered. Since there is apparently no way to proscribe all means of bid transmission that breed errors, forbidding telegraphic bids alone seems unwarranted.

Fortunately, little harm is caused by the restriction on telegraphic bids. Those who wish to submit a last-minute price can do so by mailing a bid followed by a telegraphic modification. The person who submits a telegraphic bid in the teeth of an express prohibition deserves little sympathy. However, the Government may occasionally have to reject a low bid because it was telegraphed. Thus the harm, though slight, is real. The absence of a compensating justification indicates that the restriction should be eliminated.

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**By Order of the Secretary of the Army:**

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**Distribution :**

*Active Army:* To be distributed in accordance with DA Form 12-4 requirements.

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☆ U. S. GOVERNMENT PRINTING OFFICE: 1962—650516