

## An Economic Perspective on the Law of Excessive Profits Recovery

American experience with the recovery of defense contractors' excessive profits has been extensive. During this century, the United States government has employed a variety of means to recover profits it perceived as excessive, including: profit taxes, maximum profit ceilings, and an approach under which contracts producing excessive profits were renegotiated to return such profits to the Treasury. The last of these—renegotiation of government contracts—has been the prevailing approach for the past quarter century under the Renegotiation Act of 1951.<sup>1</sup> Congress, however, has recently cut off funds for the Renegotiation Board, the agency charged with administration of the Act, and has allowed the coverage of the Act to lapse. As a result, long dormant profit ceilings imposed by the Vinson-Trammell Act have come into force.<sup>2</sup>

The merits of recovering excessive profits have been vigorously debated.<sup>3</sup> Much of the serious criticism has focused upon the seemingly arbitrary and unpredictable manner in which the courts and administrative agencies have approached the process of identifying and measuring excessive profits.<sup>4</sup> There has not emerged, however, in either the courts or the commentary, a consistent legal and eco-

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<sup>1</sup> 50 U.S.C. app. §§ 1211-1231 (1970) as amended, 50 U.S.C. app. §§ 1212(c)(1), 1213(f), (i), 1215(a), (b)(1), (b)(2), 1216(a), 1218, 1218(a), 1222, 1224 (Supp. V 1975).

<sup>2</sup> 10 U.S.C. §§ 2382, 7300 (1976). These two sections, collectively known as the "Vinson-Trammell Act," were originally enacted as section 3 of Act of Mar. 27, 1934, Pub. L. No. 73-135, 48 Stat. 503.

<sup>3</sup> For example, legal scholarship has dissected the rationale, see Coggeshall, *Basic Principles of Renegotiation*, in *PROCUREMENT AND PROFIT RENEGOTIATION* 43 (J.F. Weston ed. 1960) [hereinafter cited as *PROCUREMENT*]; Fensterstock, *The Rationale of Renegotiation*, 16 *FED. B.J.* 87 (1956), the effect, see Christenson, *Economic Implications of Renegotiation of Government Contracts*, 52 *J. POLITICAL ECON.* 48 (1944), the constitutionality, see Collier, *Constitutionality of Statutory Renegotiation*, 10 *LAW & CONTEMP. PROBS.* 353 (1944); Page, *Renegotiation: Where We Are Now*, 35 *FED. B.J.* 63 (1976); Sharp, *Comments on Renegotiation and the Constitution*, 11 *U. CHI. L. REV.* 271 (1944), and the need for reform, see Aronowitz, *Report of the Committee on Claims Adjudication in Support of Recommendation No. 22*, in 1 *RECOMMENDATIONS AND REPORTS OF THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES* 665, 674-83 (1970); Marcus, *The Need for Standards in Renegotiation and Other Determinations of Defense Profits*, 32 *GEO. WASH. L. REV.* 23 (1963); Nichols, *Equalizing Profit and Loss in Renegotiation*, 45 *VA. L. REV.* 41 (1959); Weston, *Issues Developed by the Conference*, in *PROCUREMENT*, *supra*, at 199; Note, *Reform of the Renegotiation Process in Government Contracting*, 39 *GEO. WASH. L. REV.* 1141 (1970), of the renegotiation of excessive profits, and analyzed the economics of renegotiation, see Burns, *The Tax Court and Profit Renegotiation*, 13 *J.L. & ECON.* 307 (1970).

<sup>4</sup> See, e.g., Weston, *Introduction and Statement of Issues*, in *PROCUREMENT*, *supra* note 3, at 1, 7-8.

nomic analysis of excessive-profit recovery. The problems addressed by this comment are both definitional and operational: a definition of "excessive" profits must be articulated that is consistent with the justification for profit recovery, and a consistent and practicable way of measuring profits must be developed in order to apply this concept once it is adequately defined. Although Congress has recently eviscerated the Renegotiation Act, the concept of excessive-profit recovery is not dead. The Vinson-Trammell Act remains in force, and it is unlikely that Congress will entirely eliminate statutory profit limitation of government defense contracts.<sup>5</sup> Indeed, the uncertain future of this form of government economic regulation makes it important to reexamine the economic rationale of excessive-profits recovery and the recent performance of the courts and agencies charged with recovering these profits.

### I. HISTORY, STRUCTURE, AND COVERAGE OF THE ACTS

Statutory regulation of profits from government defense contracts has evolved through legislation enacted in wartime, peacetime, and intermediate states of "national emergency." During the First World War, Congress enacted an excessive-profits tax<sup>6</sup> to help finance the increase in government expenditures and to capture profits purportedly resulting from increased wartime demand.<sup>7</sup> Congress's next measure to restrict the profits of defense contractors was the passage in 1934 of the Vinson-Trammell Act,<sup>8</sup> which established a fixed profit ceiling of 10 percent on naval and aircraft contracts. In response to the sharply increased defense procurement demands of World War II, Congress enacted a new excess-profits tax,<sup>9</sup> suspending temporarily the provisions of the Vinson-Trammell Act.<sup>10</sup> This tax proved inadequate in controlling excessive defense expenditures,<sup>11</sup> however, and Congress replaced it first with the renegotia-

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<sup>5</sup> An Undersecretary of Defense has noted that the Vinson-Trammell Act is obsolete and should be repealed, yet it has been noted that "this could take years because many in Congress would fight for a new law to regulate defense contractor profits." Wall St. J., Sept. 5, 1978, at 4, col. 2.

<sup>6</sup> 39 Stat. 1000 (1917) (expired 1921).

<sup>7</sup> Adams, *Excess Profits Tax*, in 5 ENCYCLOPAEDIA OF THE SOCIAL SCIENCES 664 (1931).

<sup>8</sup> Act of Mar. 27, 1934, Pub. L. No. 73-135, § 3, 48 Stat. 503 (current version codified at 10 U.S.C. §§ 2382, 7300 (1976)).

<sup>9</sup> Excess Profits Tax Act of 1940, Pub. L. No. 76-801, § 201, 54 Stat. 974 (repealed 1956).

<sup>10</sup> *Id.* § 401.

<sup>11</sup> The tax had two shortcomings: first, it did not eliminate the "evils" of cost-plus contracts which gave contractors no incentive to operate efficiently, and, second, it did not eliminate disparities resulting from firms that could offset profits with disproportionately high tax credits. See 17 TEMP. L.Q. 82, 82 (1942).

tion provision of the Sixth Supplemental National Defense Appropriations Act of 1942,<sup>12</sup> then with the Renegotiation Act of 1943.<sup>13</sup> The major change of the 1943 Act was the replacement of contract-by-contract renegotiation with an annual accounting and renegotiation of defense contractors' profits.

Experience with the renegotiation concept during the war proved highly successful;<sup>14</sup> this success ultimately led to the passage of the Renegotiation Act of 1951<sup>15</sup> (the "Renegotiation Act"), which again suspended, but did not repeal, the Vinson-Trammell Act.<sup>16</sup> The Renegotiation Act applied to contracts with specified agencies and departments,<sup>17</sup> subject to exemptions based on amount of sales,<sup>18</sup> nature of product,<sup>19</sup> and nature of contract.<sup>20</sup> With the passage of the Renegotiation Act, Congress also created a new federal agency, the Renegotiation Board, to administer and enforce the new law.<sup>21</sup> Specifically, the Renegotiation Board was assigned the task of determining, in light of factors enumerated in the Act, what portion, if any, of defense contractors' profits were "excessive."<sup>22</sup> Firms subject to the Act were required to file reports with the Board containing sales, profits, losses, and other financial data,<sup>23</sup> which were screened and subjected to accounting analysis to determine the likelihood of the existence of excessive profits.<sup>24</sup>

<sup>12</sup> Ch. 247, § 403, 56 Stat. 245 (1942) (current version at 50 U.S.C. app. § 1191 (1970)).

<sup>13</sup> Ch. 239, 57 Stat. 564 (1943) (current version at 50 U.S.C. app. § 1191 (1970)).

<sup>14</sup> See 17 TEMP. L.Q. 82, 84 (1942).

<sup>15</sup> Ch. 15, 65 Stat. 7 (1951) (current version at 50 U.S.C. app. § 1211 (1970)).

<sup>16</sup> *Id.* § 102(d) (current version at 50 U.S.C. app. § 1212(e) (1970)).

<sup>17</sup> The departments and agencies are listed at 50 U.S.C. app. § 1213(a) (1970). They include: the Departments of Defense, Navy, Air Force, and Army, the National Aeronautics and Space Administration, the Atomic Energy Commission (now the Nuclear Regulatory Commission), and "any other agency of the Government exercising functions having a direct and immediate connection with the national defense and which is designated by the President during a national emergency proclaimed by the President, or declared by the Congress." *Id.*

<sup>18</sup> 50 U.S.C. app. § 1215(f)(1) (1970).

<sup>19</sup> Mandatory exemptions are provided for certain products. See, e.g., 50 U.S.C. app. § 1216(a)(2) (1970) (agricultural products in their raw state).

<sup>20</sup> Permissive exemptions are provided for certain contracts. See, e.g., 50 U.S.C. app. § 1216(d)(5) (1970) (contracts where separation of renegotiable and nonrenegotiable profits is not administratively feasible).

<sup>21</sup> Renegotiation Act of 1951, ch. 15, § 107, 65 Stat. 7 (current version at 50 U.S.C. app. § 1217(a) (1970)). Since its creation in 1951 through fiscal year 1977, the Board required the disgorgement of over \$1.1 billion of profits deemed excessive. 22 RENEGOTIATION BD. ANN. REP. 12 (1977).

<sup>22</sup> The factors are enumerated in 50 U.S.C. app. § 1213(e) (1970). See also 32 C.F.R. § 1460.8-.15 (1977) (regulations interpreting statutory factors).

<sup>23</sup> 50 U.S.C. app. § 1215(e)(1) (1970). See also 32 C.F.R. pt. 1470 (1977).

<sup>24</sup> 32 C.F.R. § 1471.1 (1977). Filings that reported profits that were clearly not excessive were disposed of with the issuance of a notice of clearance, 32 C.F.R. §§ 1471.1, 1498.6(b) (1977); otherwise filings were assigned to a regional renegotiation board for further examina-

The coverage of the Renegotiation Act was limited to receipts from contracts otherwise subject to the Act that were accrued or received prior to the statute's "termination date."<sup>25</sup> The original termination date of December 31, 1956, was consistently changed by a series of amendments to extend the coverage of the Act through September 30, 1976.<sup>26</sup> Congress has failed, however, to revive the Act since its coverage lapsed in 1976. Opinion in Congress exhibited a full spectrum of positions on the continuing need for the Act: some congressmen advocated repealing the Act altogether in peacetime,<sup>27</sup> while others advanced President Carter's view that the authority of the Renegotiation Board should be strengthened to "bear down hard on excessive profits in government contracts."<sup>28</sup> Congress followed neither approach; it failed to extend the Act and voted to terminate funding for the Board.<sup>29</sup>

The recent action of Congress with respect to the Renegotiation Act seemed to result not from close analysis of the propriety of peacetime profit renegotiation,<sup>30</sup> but rather from disillusionment with the performance of the Renegotiation Board.<sup>31</sup> The Board was attacked for its increased spending and decreased efficiency in processing cases and successfully recovering excessive profits.<sup>32</sup> Al-

tion. *Id.* § 1471.1. In many cases the Board and the contractor were able to reach agreement on the amount of excessive profits to be disgorged. See 22 RENEGOTIATION BD. ANN. REP. 14 (1977) (83.2 percent). See also 32 C.F.R. pt. 1474 (1977) (agreement procedures). If no agreements were reached, however, the Board issued a unilateral order determining the amount of excessive profits, see 50 U.S.C. app. § 1215(a) (1970), which the contractor might then challenge by filing a petition for de novo review in the Court of Claims. *Id.* § 1218 (Supp. V 1975) (amending 50 U.S.C. app. § 1218 (1970)).

<sup>25</sup> 50 U.S.C. app. § 1212(d)(1) (1970 & Supp. V 1975).

<sup>26</sup> The amendments extending the coverage of the Act are set forth at 50 U.S.C. app. § 1212 note (1970 & Supp. V 1975).

<sup>27</sup> H.R. 5257, 95th Cong., 1st Sess. (1977) (a bill to provide that the Renegotiation Act shall only be in effect during a period of national emergency).

<sup>28</sup> Wall St. J., Sept. 5, 1978, at 4, col. 2. See, e.g., H.R. 4082, 95th Cong., 1st Sess. (1977) (a bill to revise and extend the Renegotiation Act).

<sup>29</sup> Department of State, Justice, and Commerce, the Judiciary, and Related Agencies Appropriation Act, 1979, Pub. L. No. 95-431, tit. V, 92 Stat. 1021 (the Renegotiation Board is funded only through March 31, 1979; all the Board's property is to be transferred to the GSA upon cessation of the Board's activities or on March 31, 1979, whichever first occurs).

<sup>30</sup> But see 123 CONG. REC. E1922 (daily ed. Mar. 30, 1977) (remarks of Rep. McCloskey).

<sup>31</sup> The House Report was highly critical of the Board: "The Committee feels that the Board should be concentrating on the disposition of backlog, yet the record would indicate that they have spent time re-writing regulations and practices even though the Renegotiation Act has not been extended." H.R. Rep. No. 1253, 95th Cong., 2d Sess. 51 (1978). The Board was, in addition, a victim of the congressional movement to cut back on the federal bureaucracy. See Letter from Representative Paul N. McCloskey, Jr. to Colleagues (April 12, 1978) ("Would you like to abolish one federal agency before we adjourn?") (on file with *The University of Chicago Law Review*).

<sup>32</sup> See Washington Post, July 9, 1978 ("We could have passed on an extension easy if that board was a competent agency.") (quoting Representative Minish).

though the Board no longer has authority to subject profits received or accrued after September 30, 1976, to renegotiation, it has operated since the termination date in order to process its 1900-case backlog. The recent House appropriations bill,<sup>33</sup> by cutting off funds to the Board after March 31, 1979, will allow the Board to dispose of only a small fraction of cases that fall within the ambit of the Act.

As a result of the failure of Congress to extend the Renegotiation Act, the Vinson-Trammell Act, which is enforced and administered by the Internal Revenue Service, is currently in force with respect to receipts and accruals attributable to performance of government contracts after September 30, 1976.<sup>34</sup> The present version of the Vinson-Trammell Act imposes profit ceilings of 10 percent and 12 percent on contracts for the manufacture of all or part of any naval vessel or aircraft, respectively, but excludes contractors whose total receipts from such contracts are less than \$10,000 per year.<sup>35</sup> The existing regulations under the Act, written in 1937,<sup>36</sup> have been described as "arcane," and the I.R.S. is in the process of drafting new regulations.<sup>37</sup> While the precise content of these regulations is still uncertain, it is apparent that contractors subject to the Act will be required to file reports with the relevant military department and remit to the Treasury any profits in excess of the statutory ceilings.

## II. IDENTIFICATION OF EXCESSIVE PROFITS

It has been asserted that defense contracts are susceptible to profiteering because the competitive market fails to confine industry pricing to marginal cost.<sup>38</sup> The argument attributes this failure

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<sup>33</sup> Department of State, Justice, and Commerce, the Judiciary, and Related Agencies Appropriation Act, 1979, Pub. L. No. 95-431, tit. V, 92 Stat. 1021.

<sup>34</sup> The provisions of the Vinson-Trammell Act were suspended only so long as the Renegotiation Act was in effect. See 50 U.S.C. app. § 1212(e) (1970).

<sup>35</sup> 10 U.S.C. §§ 2382(g)(2), 7300(g)(2) (1976).

<sup>36</sup> See 1937-1 C.B. 519-32.

<sup>37</sup> Wall St. J., Sept. 5, 1978, at 4, col. 2.

<sup>38</sup> The central truth, as I see it, is there simply [is] no traditional marketplace to guide pricing for a large part of the defense and space procurement. The Navy cannot go out in the ordinary marketplace and buy a Polaris missile. NASA cannot buy commercially a Surveyor or an Apollo.

112 CONG. REC. 13289 (1966) (remarks of Rep. Mills).

Professor Peck has argued that the weapons market is not a competitive market for four reasons: (1) the tremendous expense of weapons development precludes private financing; (2) weapons development and production are characterized by a higher degree of uncertainty than exists in other markets; (3) the government's desires for products are unpredictable, and this precludes private product development; and (4) weapons are too unique to permit effective product substitution. M. PECK & F. SCHERER, *THE WEAPONS ACQUISITION PROCESS: AN ECONOMIC ANALYSIS* 57-60 (1962).

Nevertheless, it is not clear that these factors preclude the existence or development of

to several peculiarities of the defense procurement process: the frenetic pace and heightened demand characteristic of wartime procurement that may enable contractors to extract a supracompetitive price,<sup>39</sup> the complexity of defense products that may put government negotiators at the mercy of industry cost estimates,<sup>40</sup> and the lack of incentive of government negotiators to strike the best deal possible.<sup>41</sup>

Implicit in the Renegotiation Act's response to this perceived failure of the market is the assumption that profits should be the primary measure of the magnitude of the resulting market failure. Because efforts to recover profits of government contractors presuppose a concept of normal profit, critical analysis of the Renegotiation Act, or any similar profit regulation scheme, requires the development of a basis for distinguishing between "normal" and "above-normal" profits and for identifying those above-normal profits that should be deemed "excessive."<sup>42</sup>

#### A. The Economic Concept

The concept of profit carries a variety of meanings.<sup>43</sup> It is particularly important to distinguish between profit as the term is used in economic theory and as it is used in accounting theory. Profit in its accounting sense represents the excess of revenues over costs incurred, including such noncash items as depreciation.<sup>44</sup> Profit in

a competitive market for weapons. See Stigler & Friedland, *Profits of Defense Contractors*, 61 AM. ECON. REV. 692, 694 (1971). It should also be noted that only a small part of renegotiable business (although presumably all contracts subject to the Vinson-Trammel Act) is related to weapons. See COMPTROLLER GENERAL, *CAUSES OF EXCESSIVE PROFITS ON DEFENSE AND SPACE CONTRACTS* 7-8 (1975).

<sup>39</sup> See Osborn, *Background and Evolution of the Renegotiation Concept*, in *PROCUREMENT*, *supra* note 3, at 14-38, for an account of the effects of the wartime emergency on government procurement during wars from the French and Indian through the Korean.

<sup>40</sup> See Coggeshall, *supra* note 3, at 45-46.

<sup>41</sup> Government officials may lack incentives to operate efficiently. If a corporation is run inefficiently, then it becomes an attractive target for a takeover bid. The purchaser will be able to capitalize the gains from replacing inefficient management with more efficient management. This incentive, however, is wholly absent in the operation of government agencies. See generally Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 787-89 (1972). It is also suggested that government procurement officers lack the ability needed for effective negotiation. See M. PECK & F. SCHERER, *supra* note 38, at 85-94.

<sup>42</sup> See note 48 *infra*.

<sup>43</sup> Weston, *A Generalized Uncertainty Theory of Profit*, 40 AM. ECON. REV. 40, 40 (1950). See also R. LIPSEY & R. STEINER, *ECONOMICS* 196 (1966) ("It is important to be clear about different meanings of the term profit not only to avoid fruitless semantic arguments but also because a theory that predicts that certain behavior is a function of profits defined one way will not necessarily predict behavior accurately given some other definition.")

<sup>44</sup> See, e.g., J. DUE & R. CLOWER, *INTERMEDIATE ECONOMIC ANALYSIS* 370-71 (5th ed. 1966).

economics is defined as the excess of revenues over opportunity costs.<sup>45</sup> The difference between the economic and accounting conceptions is that "the accountant does not include as costs charges for risk-taking and use of the owners' own capital,"<sup>46</sup> and that the accountant uses historical rather than current market valuation of assets.

A further distinction is sometimes drawn in economics between "normal" and "above-normal" profit. Normal profit is defined with respect to conditions of long-run industry equilibrium: normal profits are "returns to capital and risk-taking just necessary to prevent the owners [of the firm] from withdrawing from the industry."<sup>47</sup> Above-normal profits,<sup>48</sup> then, are defined as "a return on investment in excess of that obtainable elsewhere,"<sup>49</sup> and when above-normal profits are zero the firm or entrepreneur is earning a normal profit. Normal profit, thus, is equal to the imputed cost of invested capital, adjusted for risk.<sup>50</sup>

The significance of profitability, and the importance of distinguishing between normal and above-normal profit, lies in the relation of these concepts to the criterion of economic efficiency.<sup>51</sup> Five

<sup>45</sup> See, e.g., R. LIPSEY & P. STEINER, *supra* note 43, at 196; R. LEFTWICH, *THE PRICE SYSTEM AND RESOURCE ALLOCATION* 190 (4th ed. 1970) (profit equals the excess of revenue over costs; "included as costs are obligations incurred for all resources used to what those resources could earn employed in their next best alternative use"); cf. P. SAMUELSON, *ECONOMICS* 618-26 (9th ed. 1973) (identifying six distinct conceptions of profit); Davis, *The Current State of Profit Theory*, 42 *AM. ECON. REV.* 245, 245 (1952) ("The anarchic condition of . . . [profit] theory is notorious.").

<sup>46</sup> R. LIPSEY & P. STEINER, *supra* note 43, at 196. See also R. POSNER, *ECONOMIC ANALYSIS OF LAW* 187 (1972) ("[I]n a competitive market there are no 'profits' in an economic sense. There are accounting profits but they are just equal to the cost of attracting and retaining capital in the business.").

<sup>47</sup> R. LIPSEY & P. STEINER, *supra* note 43, at 196. Accord, F. VAN DEN BOGAERDE, *ELEMENTS OF PRICE THEORY* 133 (1967) ("Normal profit is defined as the profit emerging in a condition of equilibrium, which would mean that firms would not be able to improve their position by the expedient of entering another market."). *But cf.* Weston, *supra* note 43, at 52 ("there is no 'normal profit'") (footnote omitted); Dobb, *Entrepreneur*, in 5 *ENCYCLOPAEDIA OF THE SOCIAL SCIENCES* 558, 559 (1931) ("There is no normal profit, since *ex hypothesi* profit is incalculable deviation of the actual from the anticipated.").

<sup>48</sup> The term "above-normal profits" will be used consistently throughout this comment as synonymous with the other economic terms—"excess," "pure," "economic," and "pure economic" profit, see J. BAIN, *INDUSTRIAL ORGANIZATION* 387 (2d ed. 1968)—that have been applied as labels for the profit concept described herein. "Above-normal profits," rather than one of the more widely-used terms, has been adopted to distinguish more clearly such profits from "excessive profits." "Excessive profits" are those profits that are subject to recapture under one of the profit-recovery statutes.

<sup>49</sup> C. FERGUSON, *MICROECONOMIC THEORY* 272 (3d ed. 1972).

<sup>50</sup> See J. BAIN, *supra* note 48, at 388-89.

<sup>51</sup> See *id.* at 393-96.

principal reasons explain the existence of above-normal profits:<sup>52</sup> (1) the firm may possess monopoly power; (2) the firm's product may be purchased under duress;<sup>53</sup> (3) the contractual price term may be based upon inaccurate estimates of the costs of production; (4) the industry may not be in long-run equilibrium; and (5) the firm may be more efficient than other firms in the industry.<sup>54</sup> That above-normal profits are earned by a firm does not, however, necessarily indicate that resources are being inefficiently allocated. To determine the consequences of above-normal profits for efficient resource allocation, it is necessary to examine in more detail each of the five causes of above-normal profits.

1. *Monopoly Power.* Above-normal profits may be the result of a firm possessing monopoly (or monopsony) power.<sup>55</sup> Two deleterious effects on resource allocation result. First, the monopolist's supracompetitive price leads to economic inefficiency by inducing consumers to shift purchases to a less desirable product, decreasing total consumer welfare.<sup>56</sup> Second, the prospect of earning monopoly profits induces firms to devote resources to acquiring and maintaining a monopoly.<sup>57</sup> Expenditures of this sort result in a decrease in consumer welfare.<sup>58</sup> Thus, application of the economic efficiency criterion suggests that above-normal profits resulting from monopoly be recaptured.

2. *Duress.*<sup>59</sup> Duress is often defined as that which results in a forced agreement.<sup>60</sup> In this comment the term will be construed more broadly. Duress purchases produce above-normal profits in two instances in addition to forced agreement: (1) when there is insufficient time to determine the competitive price of a product

<sup>52</sup> Cf. *id.* at 397-98 (identifying four causes of above normal profits: (1) disequilibrium and misestimation of cost; (2) risk; (3) innovation and efficiency; and (4) monopoly or monopsony).

<sup>53</sup> Duress is a violation of the competition or comprehensive knowledge (itself a condition of competition) conditions that must be met for above-normal profits to be avoided. See generally R. POSNER, *supra* note 46, at 48-49 (1972); see also G. STIGLER, *THE THEORY OF PRICE* 87-89 (3d ed. 1966).

<sup>54</sup> Identifiable superior inputs that result in above-normal profits in the short-run will be capitalized as a cost in the long run. Certain efficiencies, however, may not be attributable to a specific input and will result in above-normal profits in the long run. See Demsetz, *Industry Structure, Market Rivalry, and Public Policy*, 16 J.L. & ECON. 1, 1-3 (1973).

<sup>55</sup> See C. McCONNELL, *ECONOMICS: PRINCIPLES, PROBLEMS, AND POLICIES* 570 (2d ed. 1963). See also J. BAIN *supra* note 48, at 398-402.

<sup>56</sup> See R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 10 (1976).

<sup>57</sup> See *id.* at 11.

<sup>58</sup> See *id.*

<sup>59</sup> Duress may be subsumed under monopoly, see R. POSNER, *supra* note 46, at 49, nevertheless, it is useful to refer to duress as a specific cause of excessive profits.

<sup>60</sup> BLACK'S LAW DICTIONARY 594 (4th ed. 1951).



through a thorough market search, and (2) when there is insufficient time to analyze producers' estimates of costs for deliberate inflation.<sup>61</sup> As with monopoly, above-normal profits resulting from duress indicate an economically inefficient use of resources.

3. *Inaccurate Cost Estimation.*<sup>62</sup> Even where defense contractors do not deliberately overestimate costs,<sup>63</sup> there may be serious difficulties in predicting the cost of production, especially where the goods are novel or technologically complex,<sup>64</sup> or where the volume or rate of production is uncertain.<sup>65</sup> In either case, if costs are lower than expected, above-normal profits may be earned.<sup>66</sup> Unless the misestimation is deliberate, such profits are not excessive from an economic efficiency viewpoint.

If the contract is for a fixed unit price, any above-normal profit earned may be considered a reward for the substantial risk in undertaking a contract with unpredictable costs. Moreover, any profit from reduction in cost is a reward for increased efficiency.<sup>67</sup> If the contract is an incentive contract, in which the contractor keeps a percentage of any cost-savings, then the additional profit is again a

<sup>61</sup> The contractor often has a strong incentive to inflate cost estimates because the contractor's profits will generally be set as a percentage of cost or estimated cost. See Smoot, *Procurement Practices and Renegotiation*, in *PROCUREMENT*, *supra* note 3, at 9.

The likelihood of duress can be traced to two aspects of the government-contractor transaction: the type of product provided and the nature of the contracting process. If a manufacturer produces a unique or highly specialized product, he may be able, through duress, to extract an above-normal profit. If the product is a standard commercial item, however, price information will be widely available and the dispersion of prices will be relatively small, see G. STIGLER, *THE ORGANIZATION OF INDUSTRY* 171, 181-82 (1968): the government will be able to exploit the competitive market without taking the time to obtain competitive bids. With regard to the contracting process, if the price and terms are negotiated, the delay and cost to the government of obtaining the information needed for optimal negotiation may be high, and the possibility of duress cannot be dismissed. When a contract is awarded through competitive bidding, economic theory precludes a finding of excessive profit: duress and monopoly are incompatible with competitive bidding. See G. STIGLER, *supra* note 53, at 44-45.

<sup>62</sup> See J. DUE & R. CLOWER, *supra* note 44, at 377-78.

<sup>63</sup> See note 61 *supra*.

<sup>64</sup> But only a small part of renegotiable business is technologically complex. See COMPTROLLER GENERAL, *supra* note 38, at 6.

<sup>65</sup> As the rate of production changes, so does the opportunity to exploit economies of scale. For a discussion of the sources of economies of scale, see G. STIGLER, *supra* note 53, at 153-54. As the volume of production changes, holding the rate constant, the optimal technique of production changes also. Thus, changes in rate or volume of production will cause actual costs to deviate from expected costs. See also Alchian, *Costs and Outputs*, in *THE ALLOCATION OF ECONOMIC RESOURCES* 23 (1959).

<sup>66</sup> Of course, if the contract is for a fixed unit price, the contractor will lose money if costs are greater than anticipated. In a competitive industry the price of the contract will compensate the contractor for bearing this risk.

<sup>67</sup> See Marcus, *supra* note 3, at 179-80.

prod to greater efficiency.<sup>68</sup> Finally, if the contract is for costs plus a percentage of cost, then the uncertainty of cost is totally removed and no above-normal misestimation profits are possible.

4. *Industry Disequilibrium.*<sup>69</sup> Current market or contractual price may be above the long-run equilibrium level because of a rapid increase in demand or a sudden contraction of supply. Unlike the monopoly or duress cases, the higher price represents the true social cost of production. Only if the price is allowed to rise will the product be consumed at its highest-use value. If the government, through recovery of a portion of above-normal disequilibrium profits, is able to purchase the product for a lower price than other potential consumers, then those consumers—to whom the product may be worth more—have been deprived of the product. The above-normal disequilibrium profits are required to attract the resources needed to bring the industry back to equilibrium.<sup>70</sup> Thus, above-normal disequilibrium profits are not, from an economic efficiency viewpoint, excessive.

5. *Differential Efficiency.*<sup>71</sup> Some firms in an industry may be more efficient than others. Firms that are more efficient than the least efficient firm in the industry (which, by hypothesis must make a normal profit) will make above-normal profits, and these profits may persist over time.<sup>72</sup> Above-normal differential efficiency profits are not excessive from an economic efficiency viewpoint: they do not cause inefficient substitutions in consumption or production. They merely indicate that there is a limited number of unusually efficient producers and that a single price will prevail in the market.<sup>73</sup> Above-normal profits in this case are simply a reward for efficiency.

In summary, economic theory suggests that recovery of above-normal profits attributable to monopoly or duress is consistent with the goal of achieving an efficient allocation of resources. Above-normal profits resulting from inaccurate estimation of costs, from industry disequilibrium, or from differential efficiency are not indicative of an inefficient allocation of resources and are therefore not excessive in an economic sense.

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<sup>68</sup> *Id.* at 180.

<sup>69</sup> See generally R. LEFTWICH, *supra* note 45, at 364-68; G. STIGLER, *supra* note 53, at 180-82.

<sup>70</sup> See C. McCONNELL, *supra* note 55, at 83.

<sup>71</sup> Cf. J. BAIN, *supra* note 48, at 397 (innovations, lower-cost production techniques, and more popular products).

<sup>72</sup> See generally Demsetz, *supra* note 54.

<sup>73</sup> *Id.*

## B. The Statutory Concept

The Vinson-Trammell and Renegotiation Acts embody two distinct statutory definitions of excessive profit, though they do not necessarily reflect different underlying justifications for recovery of above-normal profit. Under the Vinson-Trammell Act, excessive profit is simply the amount of a contractor's profit exceeding the statutory maximum. Identification of excessive profit under the Renegotiation Act is more complex: the Renegotiation Board, in determining the presence or absence of excessive profits, has been guided by the factors explicitly set forth in the Act. The Act directs that "favorable recognition" be given to the efficiency of the contractor "with particular regard to the attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower."<sup>74</sup> In addition, the Act requires the following factors to be considered:

(1) Reasonableness of costs and profits, with particular regard to volume of production, normal earnings, and comparison of war and peacetime products;

(2) The net worth, with particular regard to the amount and source of public and private capital employed;

(3) Extent of risk assumed, including the risk incident to reasonable pricing policies;

(4) Nature and extent of contribution to the defense effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance;

(5) Character of business, including source and nature of materials, complexity of manufacturing technique, character and extent of subcontracting, and rate of turn-over;

(6) Such other factors the consideration of which the public interest and fair and equitable dealing may require, which factors shall be published in the regulations of the Board from time to time as adopted.<sup>75</sup>

The extent to which Congress intended to adopt the economic justification for the recapture of excessive profits is not clear from the legislative histories of the Vinson-Trammell and the Renegotiation Acts.<sup>76</sup> The legislative debate on the Renegotiation Act reveals

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<sup>74</sup> 50 U.S.C. app. § 1213(e) (1970).

<sup>75</sup> *Id.*

<sup>76</sup> One commentator, writing at the time of the first congressional renegotiation statute, stated that the policies underlying renegotiation of government contracts were that "excessive and unreasonable profits should be recaptured and that 'reasonable' profits should be allowed in order to promote 'efficient' production of war goods." 17 *TEMP. L.Q.* 82, 84 (1942). See also Bork, *Legislative Intent and the Policy of the Sherman Act*, 9 *J.L. & ECON.* 7 (1966).

that its overriding purpose was to prevent "war profiteering."<sup>77</sup> The question remains, however, whether war profiteering is a political or an economic concept, or an amalgam of both. Part of the difficulty in interpreting the legislative histories arises from the legislators' unsophisticated and sometimes confusing use of economic concepts.<sup>78</sup> In addition, the repeated extensions of the Renegotiation Act during peacetime, and the recent decisions of Congress to allow the Act to expire, to cut off funds to the Renegotiation Board, and to revitalize the Vinson-Trammell Act are frustratingly ambiguous.<sup>79</sup>

Despite the ambiguity, it is clear that Congress intended above-normal profits derived from monopoly or duress to be recaptured.<sup>80</sup> It is equally clear from the explicit language of the Renegotiation Act that Congress did not intend that above-normal profits attributable to superior efficiency or innovative, cost-saving production techniques be recaptured,<sup>81</sup> nor did Congress intend that profits constituting risk premiums be recaptured.<sup>82</sup> In these respects the legislative approach to above-normal profit recovery accords with the economic interpretation. By recognizing only limited justifications for profits deemed to be above normal, however, the statutory renegotiation approach presumptively identifies as excessive some profits that are unobjectionable from an economic point of view.

The renegotiation approach departs from the economic model by leaving open the possibility of finding excessive profits resulting from misestimation of costs<sup>83</sup> or short-term industry disequilibrium.<sup>84</sup> Where the demand for a product is increasing rapidly, for example, the legislative view is apparently that this increase in demand somehow renders the market noncompetitive, or, even if

<sup>77</sup> 97 CONG. REC. 581-610 (1951). The tenor of congressional debate was set by Senator Borah in his 1934 speech demanding that Congress "take the profits out of war." 78 CONG. REC. 3688-89 (1934). Borah's demand led to the enactment of the Vinson-Trammell Act. See Note, *Reform of the Renegotiation Process in Government Contracting*, *supra* note 3, (discussing the political content of profit recovery).

<sup>78</sup> See, e.g., 97 CONG. REC. 587-88 (1951) (remarks of Rep. Vinson); 112 CONG. REC. 13289 (1966) (remarks of Rep. Mills).

<sup>79</sup> For example, Representative McCloskey's argument that the Renegotiation Act is no longer economically required, 123 CONG. REC. E1922 (daily ed. Mar. 30, 1977), is inconsistent with the reactivation of the Vinson-Trammell Act.

<sup>80</sup> See, e.g., 97 CONG. REC. 582 (1951).

<sup>81</sup> 50 U.S.C. app. § 1213(e) (1970).

<sup>82</sup> *Id.*

<sup>83</sup> The House Report stated that the Renegotiation Act was specifically aimed at those contracts in which accurate cost estimation was impossible. See H.R. REP. NO. 7, 82d Cong., 1st Sess. 2 (1951).

<sup>84</sup> See COMPTROLLER GENERAL, *supra* note 38, at 15-16. See also *Lichter v. United States*, 334 U.S. 742, 760 n.6, 762 n.7 (1947).

the market is assumed to be competitive, that above-normal profits should be treated as excessive *because of* the disequilibrium. The legislative decision to recover above-normal profits attributable to both disequilibrium and misestimation of costs reflects a use of the concept of duress in its looser, noneconomic sense: the government, because of the exigencies of war, is at a perceived bargaining disadvantage, and defense contractors should not be able to profit from the unfavorable conditions under which the government must procure its defense goods.<sup>85</sup>

The approach of the Vinson-Trammell Act diverges even more significantly from the economic argument for recovery of above-normal profits. The Act applies an arbitrary and simplistic test to identify excessive profits: a profit rate in excess of the statutory maximum gives rise to an irrebuttable presumption that the contractor has earned an excessive profit; a profit rate below the statutory ceiling is irrebuttable proof that the profit earned is not excessive, even though the criterion of economic efficiency might indicate that recovery of the above-normal profit is appropriate.

### III. THE IDENTIFICATION AND MEASUREMENT OF EXCESSIVE PROFITS

#### A. An Overview

The task of identifying and measuring excessive profits is difficult regardless of whether an economic or a statutory approach is adopted.<sup>86</sup> Both approaches suggest that the identification and measurement procedures should be causally based. Under such an approach, each firm's profits would be subjected to scrutiny; if the firm's profits arose from impermissible sources (monopoly or duress under the economic approach; monopoly, duress, misestimation, or short-run disequilibrium under the Renegotiation Act approach), then the firm's profits should be recaptured. Yet such an approach would be impossible to implement and administer due to the nature of the required causal inquiry.<sup>87</sup> The only feasible approach is a system of presumptions based upon statistical norms.

The basic datum in such a system is the firm's accounting

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<sup>85</sup> See James, *Renegotiation—An Answer and Its Problems*, 11 U. CHI. L. REV. 204 (1944). In essence, renegotiation, like the conscription of men into the armed forces, is a tax on a specific group. See Oi, *The Economics of the Draft*, 57-2 AM. ECON. REV. 39 (1967).

<sup>86</sup> See, e.g., Gillette, *Accounting Aspects of Renegotiation*, in *PROCUREMENT*, *supra* note 3, at 109.

<sup>87</sup> Cf. R. POSNER, *supra* note 56, at 55-71 (identifying 12 conditions that are favorable to collusion). *But cf.* Steiner, *Book Review*, 44 U. CHI. L. REV. 873, 888 (1977) (questioning the empirical applicability of the factors identified by Posner).

profit—a dollar amount.<sup>88</sup> This accounting profit must be transformed into a form amenable to comparative evaluation.<sup>89</sup> Theory suggests that the proper basis for comparison is the ratio of accounting profits-to-invested capital.<sup>90</sup> In certain situations, however, this ratio will not be meaningful,<sup>91</sup> in such situations the ratio of accounting profits-to-net sales may serve as a satisfactory proxy.<sup>92</sup>

Once firms' profits have been converted into ratio form, a "filter level" must be set.<sup>93</sup> If the firm's profit ratio is below the filter level, then an irrebuttable presumption arises that the firm has not earned any above-normal profits. If the firm's profit ratio is at or above the filter level, then the firm's profits must be subjected to further analysis, the purpose of which is to determine whether the firm's above-normal profits are explainable as arising from unobjectionable sources (*e.g.*, superior efficiency). If, after the analysis, the firm's profit ratio is still supranormal, then the presumption arises that the firm has earned excessive profits that ought to be recaptured.

## B. The Renegotiation Approach

The determination and recapture of excessive profits by the Renegotiation Board is based upon an application of statutory factors.<sup>94</sup> The Renegotiation Board, however, refused to assign explicit weights to these statutory factors.<sup>95</sup> More significantly, for years the Board refused to make "public either its decisions in individual

<sup>88</sup> See *Camel Mfg. Co. v. United States*, 572 F.2d 280, 285 (Ct. Cl. 1978).

<sup>89</sup> See *id.*

<sup>90</sup> See F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 80 (1970) ("Using profits as a percentage of net worth or stockholders' equity best satisfies the assumptions of economic theory"). This is because the firm, at least in theory, seeks to maximize the shareholders' net worth. See E. SOLOMON, *THE THEORY OF FINANCIAL MANAGEMENT* 22-25 (1963); J. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 8-9 (2d ed. 1971).

<sup>91</sup> When, for example, a contractor provides just management services, see text at notes 137-144, invested capital is approximately zero, and other normative rules govern behavior. The contractor providing management services will seek to maximize his net income. See E. SOLOMON, *supra* note 90, at 24-25.

In other cases, valuation of a firm's net worth or invested capital may present grave difficulties. This is likely when goodwill and other intangibles are not recorded on the firm's balance sheet, when asset valuation—including valuation of intangibles—is at historical cost significantly below current market value, or when a contractor has both covered and noncovered contracts, requiring an allocation of capital employed.

<sup>92</sup> Cf. F. SCHERER, *supra* note 90, at 80 ("Profits as a percentage of sales is clearly deficient").

<sup>93</sup> This level must be set to balance the risk of "approving" contracts that have, in fact, generated above-normal profits against the cost of needlessly analyzing contracts that have generated no above-normal profits.

<sup>94</sup> See text and notes at notes 74-75 *supra*.

<sup>95</sup> Marcus, *supra* note 3, at 40 (1963).

cases or the reasons underlying them."<sup>96</sup> As a result it has been difficult for anyone, including Congress, to evaluate the fairness and consistency with which the Board has made its determinations of excessive profit and the extent to which it has adhered to the policies underlying the Act.<sup>97</sup> Although the Renegotiation Board's non-disclosure policy makes evaluation of the Board's methodology difficult, it is possible to assess the approach that the courts have taken to the recapture of above-normal profits under the Renegotiation Act.

Jurisdiction of de novo review of the Renegotiation Board's excessive profit determinations was, prior to 1971, vested in the Tax Court.<sup>98</sup> In 1971 jurisdiction was transferred to the Court of Claims.<sup>99</sup>

1. *The Tax Court Cases.* The early Tax Court opinions were characterized by a vague, ill-defined approach to the determination of excessive profits.<sup>100</sup> The court rarely overturned determinations of the Renegotiation Board, and the court's opinions do not indicate the focus of the court's analysis or the weight it accorded the statutory factors.<sup>101</sup>

*Vaughan Machinery Co. v. Renegotiation Board*<sup>102</sup> marked a shift from the Tax Court's unstructured approach. In *Vaughan*, the court used the ratio of accounting profits-to-sales as the primary index of comparative profitability and considered the statutory factors as possible justifications for deviation from the normal rate of return.<sup>103</sup> The next shift by the court was dictated by the characteristics of the firms involved in the renegotiation process. In a series of four cases involving production of aircraft and aircraft components, the contractors had relied heavily on government-provided

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<sup>96</sup> *Id.* at 41. This was changed somewhat by the decision in *Grumman Aircraft Eng'g Corp. v. Renegotiation Bd.*, 425 F.2d 578 (D.C. Cir. 1970) (holding that the Renegotiation Board, subject to FOIA exemptions, must disclose its orders and opinions to contractors). *Cf. Renegotiation Bd. v. Bannercraft Clothing Co.*, 415 U.S. 1 (1974) (denying injunctive relief to obtain such information).

<sup>97</sup> Marcus, *supra* note 3, at 24.

<sup>98</sup> 50 U.S.C. app. § 1218 (1970).

<sup>99</sup> Act of July 1, 1971, Pub. L. No. 92-41, § 3(a), 85 Stat. 98 (codified at 50 U.S.C. app. § 1218 (Supp. V 1975)). The transfer has been described as a coin flip which the Court of Claims lost. Gallagher, *Renegotiation at the Court of Claims: The Government's Struggle With the Burden of Proof*, 46 GEO. WASH. L. REV. 376, 376 n.3 (1978).

<sup>100</sup> *See, e.g., Waltham Screw Co. v. Renegotiation Bd.*, 31 T.C. 227 (1958); *Edell v. United States*, 28 T.C. 601 (1957); *Stoner Mfg. Corp. v. Secretary of War*, 21 T.C. 200 (1953).

<sup>101</sup> The Tax Court, during its period of jurisdiction, upheld 88.7 percent of the total amount of excessive profits as determined by the Renegotiation Board. 16 RENEGOTIATION BD. ANN. REP. 15 (1971).

<sup>102</sup> 30 T.C. 949 (1958).

<sup>103</sup> *Id.* at 959-60.

assets.<sup>104</sup> In *Boeing v. Renegotiation Board*,<sup>105</sup> for example, the court held the accounting profits-to-sales ratio inapplicable in situations involving extensive use of government facilities and equipment.<sup>106</sup> Focusing on the real investment of the firm, the *Boeing* court selected the accounting profits-to-invested capital ratio as the proper index of profitability.<sup>107</sup> These aircraft cases represent the only attempt by the court to make such use of the ratio of accounting profits-to-invested capital. Major changes in analysis did not occur until the transfer of jurisdiction to the Court of Claims.

2. *The Court of Claims Cases.* The renegotiation decisions of the Court of Claims differ from those of the Tax Court in three important respects: first, the ultimate burden of proof has shifted from the contractor to the government; second, the use of comparative profit ratios has become more sophisticated; and third, the treatment of the statutory factors has grown more explicit and quantitative.<sup>108</sup>

In *Lykes Bros. Steamship Co. v. United States*,<sup>109</sup> the Court of Claims reexamined the allocation of burden of proof in de novo judicial proceedings. The court held that the contractor has the burden of introducing proof of the accuracy of its data with respect to its finances and the statutory factors upon which it relies, but that the burden of persuasion is on the government.<sup>110</sup> The impact of the *Lykes* decision on the government's ability to establish the amount of excessive profits in subsequent Court of Claims cases has been considerable.<sup>111</sup>

<sup>104</sup> *LTV Aerospace Corp. v. Renegotiation Bd.*, 51 T.C. 369 (1968); *Offner Prods. Corp. v. Renegotiation Bd.*, 50 T.C. 856 (1968); *North Am. Aviation v. Renegotiation Bd.*, 39 T.C. 207 (1962); *Boeing Co. v. Renegotiation Bd.*, 37 T.C. 613, *appeal dismissed* 325 F.2d 888 (9th Cir. 1962), *cert. denied*, 377 U.S. 923 (1964).

<sup>105</sup> 37 T.C. 613, *appeal dismissed* 325 F.2d 888 (9th Cir. 1962), *cert. denied*, 377 U.S. 923 (1964).

<sup>106</sup> *Id.* at 644.

<sup>107</sup> *Id.*

<sup>108</sup> The effect of these changes on case results has been striking. In contrast to the Tax Court's record of upholding or increasing the Renegotiation Board's excessive profit determinations in the vast majority of cases, *see* note 101 *supra*, the Court of Claims has usually decreased or cut entirely the Board's excessive profits determinations in Renegotiation Act cases. *See, e.g.*, *Manufacturers Serv. Co. v. United States*, 582 F.2d 561 (Ct. Cl. 1978); *Camel Mfg. Co. v. United States*, 572 F.2d 280 (Ct. Cl. 1978); *Mills Mfg. Corp. v. United States*, 571 F.2d 1162 (Ct. Cl. 1978); *Blue Bell, Inc. v. United States*, 556 F.2d 1113 (Ct. Cl. 1977); *Gibraltar Mfg. Corp. v. United States*, 546 F.2d 386 (Ct. Cl. 1976); *Butkin Precision Mfg. Corp. v. United States*, 544 F.2d 499 (Ct. Cl. 1976); *Major Coat Co. v. United States*, 543 F.2d 97 (Ct. Cl. 1976); *A.C. Ball Co. v. United States*, 531 F.2d 993 (Ct. Cl. 1976); *Mason & Hanger-Silas Mason Co. v. United States*, 518 F.2d 1341 (Ct. Cl. 1975).

<sup>109</sup> 459 F.2d 1393 (Ct. Cl. 1972).

<sup>110</sup> *Id.* at 1399.

<sup>111</sup> *Compare* *Blue Bell, Inc. v. United States*, 556 F.2d 1113, 1124 (Ct. Cl. 1977), and



The second major difference between the Tax Court and the Court of Claims decisions is that the Court of Claims clearly focuses on the profit ratio at the start of its analysis. The Court of Claims has adopted two approaches to the use of profit ratios. In some cases the court has used profit ratios to construct a range of permissible, nonexcessive profits and then applied the statutory factors to determine the proper location of the contractor in the "profit hierarchy."<sup>112</sup> In other cases the court has begun with what it determined to be a reasonable rate of return and then has made appropriate adjustments to take into account the statutory factors.<sup>113</sup>

These approaches differ in that the "profit hierarchy" approach is more likely to reward risk-taking, since it emphasizes the dispersion rather than the mean of profits. It is the preferred approach when the court has sufficient information about the characteristics of the firms being used as the bases of comparison to make the profit hierarchy meaningful. It is important to stress that the contractor need not fall *within* the profit hierarchy; if the contractor is more efficient or assumes more risk than the other contractors, the retention of above-normal profits may promote an efficient allocation of resources.<sup>114</sup>

The third major difference between the Tax Court and Court of Claims approaches is their treatment of the statutory factors.<sup>115</sup> *Major Coat Co. v. United States*<sup>116</sup> and its progeny<sup>117</sup> exemplify the

*Gibraltar Mfg. Corp. v. United States*, 546 F.2d 386, 394 (Ct. Cl. 1976) (court noted "scantiness" of the record and allowed a determination of excessive profits only because of the comparative novelty of trials under the burden of proof rules) *with Major Coat Co. v. United States*, 543 F.2d 97, 111 (Ct. Cl. 1976), and *A.C. Ball Co. v. United States*, 531 F.2d 993, 1016-17 (Ct. Cl. 1976). For discussions of the impact of the transfer of jurisdiction to the Court of Claims, see Gallagher, *supra* note 99; Yannello, *Judicial Proceedings in Renegotiation Act Cases*, 24 AM. U.L. REV. 339 (1975).

<sup>112</sup> See, e.g., *Major Coat Co. v. United States*, 543 F.2d 97, 102, 111 (Ct. Cl. 1976); *A.C. Ball Co. v. United States*, 531 F.2d 993, 1016-17 (Ct. Cl. 1976); *Mason & Hanger-Silas Mason Co. v. United States*, 518 F.2d 1341, 1364-65 (Ct. Cl. 1975).

The phrase "profit hierarchy" is traceable to Marcus, *supra* note 3, at 47. The courts have since adopted his language. See, e.g., *Aero Spacelines, Inc. v. United States*, 530 F.2d 324, 340 (Ct. Cl. 1976).

<sup>113</sup> See, e.g., *Blue Bell, Inc. v. United States*, 556 F.2d 1113, 1125-26 (Ct. Cl. 1977); *Gibraltar Mfg. Corp. v. United States*, 546 F.2d 386, 388, 391 (Ct. Cl. 1976); *Butkin Precision Mfg. Corp. v. United States*, 544 F.2d 499, 505-06 (Ct. Cl. 1976).

<sup>114</sup> See, e.g., *Camel Mfg. Co. v. United States*, 572 F.2d 280, 285 (Ct. Cl. 1978) ("High profits may not be 'excessive' profits if they are justified by a statutory factor.").

<sup>115</sup> See, e.g., *A.C. Ball Co. v. United States*, 531 F.2d 993, 1007-10 (Ct. Cl. 1976) (discussing risk); *Blue Bell, Inc. v. United States*, 556 F.2d 1113 (Ct. Cl. 1977) (discussing reasonableness of costs and profits).

<sup>116</sup> 543 F.2d 97 (Ct. Cl. 1976).

<sup>117</sup> E.g., *Page-River-Curran v. United States*, 574 F.2d 1063 (Ct. Cl. 1978); *Camel Mfg. Co. v. United States*, 572 F.2d 280 (Ct. Cl. 1978); *Blue Bell, Inc. v. United States*, 556 F.2d 1113 (Ct. Cl. 1977).

Court of Claims's explicit and quantitative handling of the Renegotiation Act's statutory factors. In *Major Coat* the court divided the factors into two groups. First, it considered the character of the business, its net worth, and the capital employed,<sup>118</sup> in order to identify those firms (including the contractor itself) that were sufficiently similar to the contractor to allow construction of a profit hierarchy.<sup>119</sup> Second, the court considered the contractor's efficiency, risks assumed, and contribution to the defense effort,<sup>120</sup> in order to determine where in the hierarchy the contractor properly belonged.<sup>121</sup>

#### IV. A PROPOSED REFINEMENT OF THE COURT OF CLAIMS APPROACH

##### A. Reference Frames for Determining Profitability

The Court of Claims, although recognizing a role for the profit-to-net worth and profit-to-invested capital ratios,<sup>122</sup> has consistently employed the ratio of profit-to-sales as the basis for its analysis of above-normal profits.<sup>123</sup> Primary reliance on the profit-to-sales ratio may, in special circumstances, be justified.<sup>124</sup> In general, however, the profit-to-invested capital ratio provides the more appropriate basis for analysis:<sup>125</sup> reliance on a profit-to-sales ratio may give results that are completely inconsistent with efficient allocation of resources.

Consider two firms, producing identical products, both financed solely with equity capital. The product of the first firm is produced on outdated, relatively inefficient machinery. The firm sells \$1 million of product and has a profit of \$10,000. Thus, its profit-to-sales ratio is 1 percent. The second firm, however, employs

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<sup>118</sup> The court also recognized that the statute required consideration of the "reasonableness" of the firm's costs and profits, but noted that this factor "is more concerned with the assessment of relative efficiency," 543 F.2d at 110 n.3, and considered it at the second stage of its inquiry.

<sup>119</sup> The firms comparable to *Major Coat* ranged in profitability from 9.5 to 13.2 percent of sales. *Id.* at 122.

<sup>120</sup> Although the court purported to treat this factor as distinct, closer examination reveals that the court was really evaluating the efficiency of and risk assumed by the firm. *Id.* at 119-20.

<sup>121</sup> The court decided that *Major Coat* should be viewed as one of the most efficient producers in its industry because the government failed to carry its burden of proof that the contrary might be true. *Id.* at 117. The company's assumption of business risks was deemed "insubstantial," *id.* at 118, even though it endangered its relations with regular customers in order to undertake the government business.

<sup>122</sup> See, e.g., *Mills Mfg. Corp. v. United States*, 571 F.2d 1162, 1173 (Ct. Cl. 1978).

<sup>123</sup> See cases cited in note 108 *supra*.

<sup>124</sup> See text and notes at notes 91-92 *supra*.

<sup>125</sup> See note 90 *supra*.

the most modern machinery and also sells \$1 million of product. Its profit is \$200,000; its profit-to-sales ratio is 20 percent.

Under the Court of Claims approach, it is likely that a portion of the second firm's \$200,000 profit would be recaptured even if "credit" were to be given to the second firm for its superior efficiency. Yet, this may be totally inapposite. Suppose that the first firm has only \$100,000 of invested capital committed to the project, while the second firm has \$2 million of invested capital committed. Under such circumstances the ratio of profit-to-invested capital for both firms is 10 percent. The second firm's absolute dollar profit is higher because it includes a return on the larger amount of equity capital that the second firm has committed to the project. For excessive-profit purposes, therefore, both firms should be treated alike—not, as the profit-to-sales ratio would suggest, differently.

The analysis may also be improved by recognizing the limitations of fiscal year analysis. Determination of excessive profit normally proceeds on the basis of the profits and losses of a single fiscal year.<sup>126</sup> This permits a contractor to offset losses or low profits on one covered contract against high profits on another, eliminates the need for allocating costs among different contracts, and simplifies administration.<sup>127</sup> It may, however, seriously distort analysis of a firm's profits when the firm has a small number of covered contracts of greater than a year's duration. Often the low profits of early years, caused by the need for tooling-up and gaining experience, are compensated for by higher profits in later years.<sup>128</sup> The courts have, on occasion, taken note of such situations informally;<sup>129</sup> they should do so explicitly when appropriate.<sup>130</sup>

Once the proper index of profitability and time frame have been chosen, the *Major Coat* framework requires that the firm's business be examined to determine which industry, if any, should be used as a frame of reference to establish the initial estimate of normal profitability. This estimate is then modified by considering the statu-

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<sup>126</sup> 32 C.F.R. § 1457.1 (1977). The Renegotiation Act permits accounting under some other period, by mutual agreement of the contractor and the Board, 50 U.S.C. app. § 1215(a) (1970). The regulations, however, permit deviation from the fiscal year basis only to allow a limited loss carryforward. 32 C.F.R. § 1457.9 (1977). Despite the fiscal year basis, the Board will consider deficient profits in a prior year where those deficiencies result from nonrecurring costs in early stages of production. *Id.* § 1460.10(b)(5).

<sup>127</sup> *See id.* § 1457.1(b).

<sup>128</sup> *See generally* Nichols, *supra* note 3. An example is *Blue Bell, Inc. v. United States*, 556 F.2d 1113 (Ct. Cl. 1977).

<sup>129</sup> *See, e.g.*, *Blue Bell*, 556 F.2d at 1123; *Gibraltar Mfg. Corp. v. United States*, 546 F.2d 386, 388 (Ct. Cl. 1976).

<sup>130</sup> *See* Nichols, *supra* note 3.

tory factors—extent of risk assumed and source of capital—to determine the normal level of profitability, adjusted for risk. Finally, reasonableness of costs is considered relative to other producers in the relevant industry to determine how much, if any, of the above-normal profits may be justified by efficiency considerations.<sup>131</sup> This process is not difficult if an identifiable competitive industry exists. Where the product is unique or highly specialized, however, it may be difficult to decide which firms to compare with the contractor; the less similar are the firms selected for comparison, the less useful the framework will be. Only when properly comparable firms have been identified can the profit ratios be meaningfully compared.<sup>132</sup>

## B. Profit Analysis in Specific Contexts

The Renegotiation Act applies to a broad range of contracts entered into by companies of diverse size, capital structure, and efficiency. The operation of the proposed refinements in the process of identifying and measuring excessive profits can best be demonstrated by examining some of the particular problems that recur in these diverse contexts.

1. *Contracts for Novel Goods.* Many government purchases of defense and space equipment have no counterpart in the private sector. This creates difficulties for excessive-profits analysis since there are no firms sufficiently similar in size, character of business, risk assumption, or contribution to the defense effort to make a comparison meaningful. In *Aero Spacelines, Inc. v. United States*,<sup>133</sup> for example, the court recognized the necessity of comparing Aero Spacelines, the builder of the “Pregnant” and “Super” “Guppies”—unique forms of transportation—for NASA, with other firms, either in the more conventional air transportation industry or in the airframe industry.<sup>134</sup>

The great danger in such comparisons is that the contractor’s assumption of risk and introduction of innovations may not be fully recognized. In *Aero Spacelines*, for example, the “Guppies” were developed at the risk and expense of the contractor.<sup>135</sup> If Aero Space-

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<sup>131</sup> See 50 U.S.C. app. § 1213(e) (1970); 32 C.F.R. §§ 1460.10(b)(3), 1460.10(b)(4), 1460.12, 1460.13(b)(1)-(7) (1977).

<sup>132</sup> Profit ratios may be compared within each of four sets of data: firms in the contractor’s industry, government contractors in the contractor’s industry, profit record of the contractor on nonrenegotiable business, and profit record of the contractor on prior renegotiable business.

<sup>133</sup> 530 F.2d 324 (Ct. Cl. 1976).

<sup>134</sup> *Id.* at 340-41, 351.

<sup>135</sup> *Id.* at 341-42.

lines were compared with other, more conventional firms, it seems likely that the amount of excessive profits—if any—earned by Aero Spacelines would be overstated.<sup>136</sup> The result is the creation of undesirable incentives against assuming risk and against introducing innovations. The *Aero Spacelines* case exemplifies the type of situation in which the court must be sensitive to all the statutory factors to avoid reaching a result contrary to efficient defense production.

2. *Purchase of Management Services.* When the government leases to the contractor most or all of the facilities and equipment necessary for the contract, special problems are posed in determining whether the contractor has earned excessive profits. In effect, such contracts are purchases of management services:<sup>137</sup> the contractor invests little or no capital of his own.<sup>138</sup> Normally the price clause of such a contract is negotiated rather than set through competitive bidding. A cost-plus feature may be necessary because the project requirements cannot be described precisely at the time of contracting.

*Mason & Hanger-Silas Mason Co. v. United States*<sup>139</sup> is illustrative. The contractor, a manufacturer of ammunition, operated four government-owned factories on a cost-plus-fixed-fee basis.<sup>140</sup> During the early years of the Vietnam War, demand and production increased substantially. Unit cost declined because of economies of scale and effective cost control achieved by the contractor. Accordingly, the profit-to-sales ratio rose from 1.66 percent in 1965 to 2.37 percent in 1967.<sup>141</sup> It is plausible to suggest that excessive profits were earned, and that the source was either the lack of competitive bidding or the unanticipated increase in volume of production and concomitant reduction in unit costs.

The Court of Claims calculated the reasonable profit figure by averaging the 1965, pre-Vietnam War profit ratio with the adjusted, post-renegotiation, average profit-to-sales ratio of other operators of government-owned ammunition factories.<sup>142</sup> The court's methodology is analytically unsound: the court simply averaged two incom-

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<sup>136</sup> In *Aero Spacelines* itself, however, the court was not faced with these problems because the government submitted insufficient evidence to make a case for excessive profits. *Id.* at 340-41, 357, 367.

<sup>137</sup> See 32 C.F.R. § 1460.11(b)(4) (1977).

<sup>138</sup> See, e.g., *Mason & Hanger-Silas Mason Co. v. United States*, 518 F.2d 1341, 1357 (Ct. Cl. 1975) (home office and \$40,000 working capital).

<sup>139</sup> *Id.*

<sup>140</sup> *Id.* at 1344.

<sup>141</sup> *Id.* at 1360.

<sup>142</sup> *Id.* at 1365.

measurable profit ratios, without regard to comparative efficiency or defense contribution.

The court should have employed the comparative statutory factors before choosing between the two average profit ratios and attempted to evaluate the usefulness of both before undertaking to average them. The contractor's rate of profit in a supposedly "normal" year was treated as a maximum, despite evidence that the contractor's ingenuity had been responsible for cost savings in subsequent years.<sup>143</sup> Gains from economies of scale were credited largely to the government, even though it is arguable that an ammunition manufacturer deliberately accepts low profits in peacetime in order to be able to expand production when war demands it.<sup>144</sup> Rather than treat the 1.66 percent as a maximum, therefore, the court should have adjusted the profit ratio upward to account for increases in efficiency and in contribution to the defense effort, and in recognition of the fact that lower profits in peacetime might have reflected the costs of maintaining the capacity for greater production in war.

Similarly, the court erred in its treatment of the 2.7 percent average profit-to-sales ratio of government-owned facility operators. The court should have focused on the range of profits earned by such operators, from 1.7 to 6.7 percent, rather than on the mean. The court should then have considered the efficiency and contribution to the defense effort of Mason & Hangar relative to other firms to determine where in the profit hierarchy Mason & Hangar belonged. There is no a priori reason to assume Mason & Hangar to be the "average" firm.

3. *Firms with Few Government Contracts.* When a firm has few covered government contracts, its yearly profit rate will be, in effect, a contractual profit rate. Since firms will assume more risk on an individual contract than they will on their business as a whole, the dispersion of profits *on individual contracts* is likely to be far greater than the dispersion of profitability *among firms*.<sup>145</sup> To compare a one-contract firm's profits with the profits earned by multicontract firms would deny the one-contract firm the full benefit of its risk-taking.

Courts might deal with this problem in one of three ways.<sup>146</sup>

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<sup>143</sup> *Id.* at 1352-54. For example, a new engineering technique resulted in savings of \$275,700 at one plant in 1967. *Id.* at 1353.

<sup>144</sup> The court rejected Mason & Hanger's argument that the ammunition industry is "cyclical," experiencing low profits in peacetime, high profits in wartime. *Id.* at 1361.

<sup>145</sup> See W. SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* 45-73 (1970).

<sup>146</sup> The court has apparently not faced this issue, although it may have been an underly-

First, they could give particular weight to a comparison of the contractor with other firms with a small number of covered contracts, eliminating the disparity in risk. Second, they could take the greater risk of the small number of contracts into account when locating the contractor within the profit hierarchy. Third, they could use a longer period than the fiscal year for the accounting period, allowing the contractor to offset low profits in some years against high profits in other years.

4. *Firms That Subcontract Much of Their Work.* The treatment of general contractors who employ subcontractors has been a source of confusion in the Renegotiation Act cases.<sup>147</sup> The regulations somewhat inconsistently provide that "favorable recognition" be given firms that subcontract with small business concerns, but that a contractor who subcontracts work "may not reasonably expect" as high a profit as a contractor who does the work himself.<sup>148</sup> Presumably, the argument is that one who subcontracts makes less of a contribution to the defense effort, employs less capital, and shows less efficiency than the integrated manufacturer. Accordingly, in *Boeing Co. v. Renegotiation Board*,<sup>149</sup> the Renegotiation Board relied heavily on Boeing's use of subcontractors in finding excessive profits.<sup>150</sup>

Yet, subcontracting should not be discouraged by excessive-profits analysis. A firm will, in theory, subcontract work when it is efficient to do so—that is, when it will make a higher profit by doing so.<sup>151</sup> To take away these profits on a theory that the general contractor makes a smaller contribution to the defense effort is counterproductive. Efficient subcontracting is as vital a function as efficient manufacturing. When the profit-to-invested capital ratio is employed in the analysis of excessive profit, the firm that subcontracts much of its work will make a smaller absolute dollar profit; yet, there is no reason why it should make a smaller percentage profit.

## CONCLUSION

For most of this century it has been the policy of the federal

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ing problem in *Major Coat Co. v. United States*, 543 F.2d 97 (Ct. Cl. 1976).

<sup>147</sup> See Marschalk, *Small Business Experience with Renegotiation*, in *PROCUREMENT*, *supra* note 3, 72-77.

<sup>148</sup> 32 C.F.R. § 1460.14(b)(i) (1977).

<sup>149</sup> 37 T.C. 613, *appeal dismissed* 325 F.2d 888 (9th Cir. 1962), *cert. denied*, 377 U.S. 923 (1964).

<sup>150</sup> Marschalk, *supra* note 147, at 72.

<sup>151</sup> *Id.* at 75.

government to attempt to recapture excessive profits from certain defense contractors, without impairing efficient production. This comment has examined, from an economic perspective, the causes of above-normal profits in the defense industry in order to determine the circumstances in which they should be considered excessive. Adoption of efficient allocation of resources as an evaluative criterion leads to the conclusion that only those above-normal profits attributable to monopoly or duress should be considered excessive. Examination of the legislative history of the Renegotiation Act suggests Congress intended that all above-normal profits except those attributable to superior efficiency be recaptured; the Vinson-Trammell Act recaptures all profits above the statutory maxima, regardless of their cause. Although the legislative histories of the two Acts purport to serve the goal of efficient production of defense products, the definitions of excessive profit in the Acts, as construed by the courts, are not consistent with those suggested by economic analysis. It is unclear, however, whether these statutory and judicial departures from the economic view reflect a noneconomic legislative purpose or merely insufficient congressional knowledge of economic theory to articulate and implement a policy promoting economic efficiency.

Whatever the policy that statutory profit recovery is designed to serve, the task of measuring profits and determining the extent to which they are excessive remains. Judicial determination of excessive profits has improved considerably since jurisdiction of renegotiation cases was transferred to the Court of Claims. This comment has suggested further refinements in the process of measuring excessive profits and has applied this refined approach to a variety of particular cases.

Statutory profit recovery is currently at a crossroads. As a result of the termination of funding for the Renegotiation Board and the failure of Congress to extend or replace the Renegotiation Act, the legislative approach with the least theoretical merit—the imposition of profit ceilings under the Vinson-Trammell Act—has become the current law of excessive-profit recovery. Whether Congress chooses to amend the Vinson-Trammell Act, reinstate the Renegotiation Act, enact a new excessive-profit statute, or abolish profit recovery entirely, careful consideration should be given to the causes of above-normal profits and the economic consequences of recapturing those above-normal profits deemed excessive.

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