

CONTRACT BY REGULATION

ELMER J. STONE*

In October 1963, the annual meeting of the Procurement and Finance Committee of the Aerospace Industries Association (AIA) was held in San Francisco. The agenda for the conference included some two dozen items representing major problems confronting the aerospace industry in its contracting with the government. A perusal of matters under consideration by procurement committees of other industry associations and bar association committees discloses not only similar numbers of problem areas but nearly identical subject lists. Significantly, many of these continue on, year after year, either without resolution or with resolution in a manner partially or wholly unsatisfactory to one or the other of the contracting parties.

Unfortunately, the number and magnitude of frictions in the industry-government relationship appear to be on the increase. Stanford Research Institute, in a penetrating report entitled "The Industry-Government Aerospace Relationship,"¹ lists five major problems now present in this relationship. The first of these five, and one of peculiar interest to attorneys and contract specialists, is stated as:

Industry's growing concern that its technical performance, costs, income and reputation are being affected adversely by over-regulation, conflicting regulations, ineffective administration of regulations, close, and not always capable, government surveillance of its activities, and burdening of the procurement process with socioeconomic objectives.

One can say without fear of substantial disagreement that the flower of "contract by regulation" is blooming prolifically. No longer are government procurements effected through across-the-table negotiation and bargaining on all contract terms. Today ninety per cent or more of every contract is prescribed by law, regulation, or government requests for proposals. Several billions of dollars of annual procurement is effected by no more than half-a-dozen basic and unalterable contract forms. This rigidity leaves little or no room for negotiation and "tailoring" the contract to the transaction. It not infrequently causes hardships in performance and financial results. While a system such as this is inconceivable in the pure commercial world, it is accepted with some apathy by many government contractors. Perhaps a belief in the benevolence of government has caused some contractors to sign contracts without even reading the "boiler plate," a practice which can lead to grief,² losses, and not infrequently, bankruptcy.

*LL.B. 1948, University of Southern California. Chief Counsel, Missile & Space Systems Division, Douglas Aircraft Company, Inc. Member of the California bar.

¹ *The Industry-Government Aerospace Relationship*, SRI Project No. IS-4216, Vol. I, p. 2, May, 1963.

² See, e.g., Comp. Gen. Dec. No. B-13868, involving Universal Lumber Company. In this case the contractor signed a contract with the Air Force which granted contractor's proprietary rights in its product to the government. The government subsequently advertised for bids on contractor's product and the contractor appealed to the Comptroller General for relief. The finding was that the contractor had

The contract by regulation era has received its greatest impetus since the enactment of the Armed Services Procurement Act of 1947.³ After that enactment the Department of Defense commenced issuing the Armed Services Procurement Regulation (ASPR)⁴ under the authority of the act. Currently this regulation governs policies and procedures relating to the procurement of supplies and services by the Army, Navy, Air Force, and the Defense Supply Agency.⁵ Each of these agencies has implemented ASPR with additional regulations. At the time of this writing the official publication of ASPR contained 1,022 pages. Three of the official implementing regulations, the Army Procurement Procedure (APP), Navy Procurement Directives (NPD) and Air Force Procurement Instruction (AFPI) total several volumes, and, like ASPR, each of them is growing every day. It is understood that the Department of Defense plans to supplant the implementing regulations with a "super ASPR" so that, presumably, all regulations would be contained in the one publication. While this plan would seem to have merit it is doubtful that it will eliminate the flow of departmental regulations disguised under other names.

Section seven of the ASPR is devoted to contract clauses of two categories, namely, "required" clauses and "clauses to be used when applicable." Whether a required clause is appropriate to a transaction or whether circumstances, equity or good judgment dictate a modification to the clause is quite immaterial; it must go in the contract. Deviations from ASPR are permitted, however, but, except in emergency situations, only after a contracting officer notice is processed in advance to the office of the secretary of the procuring establishment.⁶ Experience has taught that contracting officers are loath to process requests for deviations and when they do the requests mire in administrative procedure, are generally opposed by interested departments and are so time consuming that contract performance may have been completed before the almost inevitable denial is received. The result of this is that negotiators resort to oral understandings, side agreements and other devices which, though of little contractual effect, lead to misunderstandings, arguments and disputes, further deteriorating the relationship between buyer and seller.

With circumstances such as they are, industry personnel have found themselves in the unique, unenviable and undesirable position of attempting to negotiate their contracts at the regulation-making table. The Department of Defense has established a group known as the ASPR Committee with the mission of studying, drafting, coordinating and issuing (over the name of the Secretary of Defense) the procurement regulations and changes thereto.⁷ This committee (under which there are specialist subcommittees) is staffed with exceptionally capable experts in law, pro-

granted the government unlimited rights in the data submitted under the contract and that there was, consequently, no basis for relief.

³ 62 Stat. 21 (1948), as amended, 10 U.S.C. §§ 2301-14 (1958).

⁴ 32 C.F.R. §§ 1.100-30.5 (Supp. 1963).

⁵ ASPR 1-102, 32 C.F.R. § 1.102 (Supp. 1963).

⁶ ASPR 1-109, 32 C.F.R. § 1.109 (Supp. 1963).

⁷ ASPR 1-105, 32 C.F.R. § 1.105 (Supp. 1963).

curement, accountancy, and other technical fields. The members are loyal, dedicated, and generally reasonable in their consideration of the sellers' problems. However, there are some important factors which affect substantially the committee's work: (1) it represents the government and, in the final analysis, is bound to favor a government position, (2) it is subject to strong and not always objective representations by individuals within the Department of Defense who are recognized as experts on a subject under consideration by the committee, and, it is submitted, (3) man is not gifted with the prescience to enable him to draft contract clauses which will fit every future transaction.

The Department of Defense has been generally faithful in coordinating its proposed ASPR regulations with industry and bar groups and permitting them to comment on the proposals and to discuss them with the committee. (Similar coordination has not been effected in the cases of AFPI, APP, and NPD, nor does NASA coordinate its proposed regulations with groups outside the government.) This procedure has certainly had the effect of minimizing difficulties between the parties but it has not been a panacea. Remaining is the fact that the government is the issuer of the regulation and thus the sole arbiter; and, as noted above, once issued there is no practical method of negotiating deviations from it.

Frequently the argument has been made that the government, being the buyer, should be permitted the unilateral right to determine the conditions under which it makes its purchases. This argument, while applicable to any purchase whether by the government or a commercial concern, is repugnant to our legal and economic system of free bargaining and certainly should not be applied if it results in our government creating an inequity vis-à-vis one of its citizens.

The difficulties and inequities in the system are illustrated in the case of the now infamous ASPR Revision No. 11 which was issued in September 1962. Although Revision No. 11 covered a multitude of changes to ASPR, a contract language change on which attention was immediately focused related to the recognition of property tax costs in the pricing of government fixed-price contracts and the allowability of such costs under cost-plus-a-fixed-fee contracts (CPFF).⁸ Industry's shocked reaction to this portion of Revision No. 11 was based in the fact that the newly prescribed contract language: (1) was grossly discriminatory as between contractors located in different states, (2) upset long-recognized and accepted methods of accounting (and charging) for taxes, (3) made unallowable certain local tax costs from which the government derived benefit and which were necessary costs of conducting a contractor's business and, last but not least, (4) (the change) was published without coordination outside the government.

Industry representatives, seeing a further incursion on constantly diminishing profits in the performance of government contracts,⁹ sought and obtained an im-

⁸ ASPR 11-401.2, 32 C.F.R. 11.401-2 (Supp. 1963); ASPR 15-205.41, 32 C.F.R. § 15.205-41 (Supp. 1963).

⁹ The after-tax profit for many of the major aerospace firms is less than 2% on sales. This compares

mediate audience with the ASPR Committee. A lively, two-hour session produced little but the fact that the ASPR Committee had been led to believe by the initiating government agency that the change to the contract language and regulation was merely a "codification" of pre-existing government policy in which industry had acquiesced! While it was true that industry was aware of individual cases where government negotiators had proposed disallowance of the taxes in question, it came as surprising and, of course, inaccurate news that industry had acquiesced in the "policy." The fact was that the now disallowed taxes had been consistently and, industry claims, properly allowed in contracts entered into under the authority of the Armed Services Procurement Act. After the issuance of Revision No. 11 some Department of Defense departments have even gone to the extent of attempting to impose the effect of the revision on contracts entered into *before* the new regulation was published.¹⁰

Since the aforementioned initial meeting with the ASPR Committee, industry has directed written and verbal appeals to several executive levels within the Department of Defense to rescind the objectionable regulation or at least suspend it until further study and debate between the parties can be effected. To the date of this writing all efforts of industry in this regard have been fruitless.

Disregarding the merits of both the government and industry positions in this matter, the real question is, in what way can an impartial and objective decision be made on problems of this kind, so that regardless of the outcome both parties may know they have "had their day in court"?

Another example of the difficulty of correcting inequities lies in the termination clause for fixed-price contracts.¹¹ In essence, the article provides that in the event of the government's termination for convenience the contracting officer and the contractor may agree on the amount owing to the contractor, which amount "may include a reasonable allowance for profit." In the event the parties fail to agree, the contracting officer determines the amount due including a "formula" profit which is based on a percentage of two per cent of unprocessed materials and eight per cent on other costs incurred in performance (but not exceeding six per cent in the aggregate). The termination article also provides that in the event any dispute arises the contractor has the right to appeal to the Armed Services Board of Contract Appeals (ASBCA).

At the time section eight of ASPR was being considered for publication by the government many government-industry meetings were held for the purpose of discussing the proposed language. The fear was expressed by industry that under the proposed termination article the contracting officer, merely by refusing to negoti-

with 8-12% for many major United States companies doing largely commercial, *i.e.*, non-government work.

¹⁰ A recent case involving this issue, *Appeal of Lockheed Aircraft Corporation*, ASBCA Docket Nos. 6196, 6197 and 6386, 64 BCA ¶ 4056 (1964), was decided adversely to the contractor. It is understood that the same cases may be litigated in the Court of Claims.

¹¹ ASPR 8-701, 32 C.F.R. § 8.701 (Supp. 1963).

ate the amount due or by offering a ridiculously low amount, could force the settlement into a formula determination which, in many cases, would penalize the contractor's profit. Government representatives, on the other hand, assured industry that in such event the contractor would be entitled to appeal the issue of reasonableness of profit to the ASBCA. Although remaining unconvinced the industry representatives had no choice but to accept the regulation as issued.

The cost of lost profits to industry on this one point over the last dozen years is incalculable though certainly substantial. Three appeals, *Appeal of Pamco Corporation*, *Appeal of General Dynamics Corporation*, and *Appeal of Douglas Aircraft Company, Inc.*,¹² illustrate the unfairness of the "formula" determination. In the *Douglas* case the redeterminable contract involved called for approximately \$1,000,000 of work (including subcontracted work) and the parties had agreed on a target profit of ten per cent, or approximately \$100,000. Both parties agreed that at the time of termination the contract was about forty-seven per cent complete and the contractor argued that it was thus entitled to forty-seven per cent (\$44,000) of the negotiated profit. On the other hand, the contracting officer took the position that in settling profit on a termination claim, work performed by a subcontractor was not "work done" in performance of the contract and offered \$12,000 in settlement of profit. When the parties failed to agree the contracting officer made a unilateral, "formula" decision. By applying the profit formula the contractor was awarded \$3,946 as his full profit on the contract. On appeal to the ASBCA, the contractor's claim for \$44,000 was denied on the ground that under the terms of the contract a formula determination on profit was final unless there was an error in application of the formula.¹³ The Board stated that the question of reasonableness of profit in a termination is not a proper subject for consideration in the disputes procedure.

In closing its decision the Board made the following remark:

The contractor dramatizes the fact that the construction we here place on the contract and our authority in the premises means that unless it accedes to the Government in negotiations under 21(d) it must suffer the greater disadvantage of a formula determination under 21(e). The contractor must protect itself against such an inequity, if that is what it is, in writing its contracts.

While one can neither fault the Board's reasoning nor its decision in the *Douglas* case, its admonition that contractor's remedy is through negotiation of its contracts has indeed a hollow ring. The termination article, ASPR 8-701, is required to be

¹² *Appeal of Pamco Corporation*, ASBCA Docket No. 3114, 57-2 BCA ¶1489 (1957); *Appeal of General Dynamics Corp.*, ASBCA Docket No. 5880, 61-1 BCA ¶2890 (1961); *Appeal of Douglas Aircraft Co., Inc.*, ASBCA Docket No. 5921, 62 BCA ¶3467 (1962).

¹³ Interestingly, had the *Douglas* case arisen under a CPFF contract there would have been little question as to the contractor's entitlement to its claim for \$44,000 of profit. The termination clause for CPFF contracts, ASPR 8-702(e)(1)(D)(I), 32 C.F.R. § 8.702(e)(1)(D)(I) (Supp. 1963) provides that in the event of termination for convenience of the government "there shall be paid a percentage of the fee equivalent to the percentage of the completion of work contemplated by the contract. . . ." This inconsistency in contract terms is explainable only on the theory that the drafters of the fixed-price contract termination article expected that the negotiation process (which failed in both *General Dynamics* and *Douglas*, *supra* note 12) would produce a similar result.

placed in every fixed-price supply contract and, as noted above, the contracting officer's authority to deviate from it is severely restricted and, as a practical matter, he will not deviate from it. Change the regulation? Since the *Douglas* decision in 1962 several meetings have been had between industry and government personnel cognizant of the problem and formal requests for changes have been forwarded to the ASPR Committee. Most government officials individually agree that an inequity exists and that remedial action is necessary. After one and one-half years, however, industry still waits, termination procedures are slowed, and another example of the necessity for modifying our present system is being recorded.

What remedial steps are possible? The Secretary of Defense, by action in mid-1962, may already have taken one in the organization of the Defense-Industry Advisory Council (DIAC), chaired by the Deputy Secretary of Defense and whose membership consists of government executives and the heads of five industrial concerns. One of the missions of the Council is to consider problems in the government-industry relationship and to make appropriate recommendations to the Secretary. While it is not expected that DIAC itself would delve into the more detailed procurement problems, it is encouraging to note that several subcommittees have been established and through them some penetration may be effected. On the negative side, however, it is understood that the government determines the agenda items and, it goes without saying, the final decision on any matter will rest with the Secretary of Defense.

How well DIAC will serve and function toward obtaining objective and impartial decisions on, or compromises of, key issues in the relationship is still an open question and it can only be answered by the government itself.

More specifically, it is submitted that two things can be done which would go far toward resolving the many "contract language regulations."

First, it is believed that contracting officers could and should be given real and practical discretionary powers to modify the ASPR contract clauses. These men are as competent as their industry counterparts and they should have the same degree of negotiation freedom. If there is concern on the part of government procurement executives over the ability of these negotiators it is within the government's power, through training and hiring, to improve the quality of the contracting officer corps. The government is further adequately protected by its contract review procedure and, in any event, most major procurement contracts must be approved at the secretary level. Contracting officer actions and decisions should be questioned or reversed only on a showing of substantial error or gross misjudgment. In advertised contracts a bidder should not be considered unresponsive if his bid proposes changes in the contract form which accompanies the government's request for bids; requested changes may always be weighed to determine the bidder's competitive standing.

Second, a more objective and impartial method must be sought for the adoption of new ASPR contract clauses and changes thereto. It has been suggested that a

form of arbitration by independent experts of disagreements between the government and industry would be a solution. The Armed Services Board of Contract Appeals, for instance, is a proven example that disputes between a contractor and the government can be resolved by the government through a method and in a manner which has been fair to both. With such a forum each side would have an opportunity to voice its position and the recommended decision could be forwarded to the Secretary of Defense for final action.

Whatever action is taken, it is submitted that its objectives should be to slow the strait-jacketing of the negotiation process in a wealth of regulations which prescribe contract terms; and, when regulations affecting the health, ability to perform, and profits of industry are deemed necessary, then every reasonable effort should be expended to make those regulations fair and acceptable to both parties. These efforts should include attempts to eliminate the contradiction currently existing between the proliferation of restrictive regulations on the one side and, on the other, the Department of Defense's desire to harness the profit motive by placing more responsibility on industry, giving it more freedom of action, and rewarding those companies whose performance is superior.