

PROBLEMS ARISING OUT OF THE SUBCONTRACTOR RELATIONSHIP

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Any program designed to cushion the economic impact of termination of war production must make adequate provision for termination of subcontracts¹ as well as prime contracts and the prompt settlement of claims under such contracts.

It is doubtful whether any accurate figures are available either as to the number of subcontractors participating in the war effort or as to the volume of business being done by them. It is undoubtedly a fact, however, that because of the manufacturing methods of American industry the number of subcontractors engaged in war production greatly exceeds the number of prime contractors, and the volume of business done by subcontractors exceeds the volume done by prime contractors.

By subcontractor is meant the holder of any purchase order, agreement or subcontract for services or materials of any kind that enter into the performance of a prime contract. This definition includes not only those companies which have contractual relationship with prime contractors but also companies whose services or materials are included in the product of the prime contractor, even though such companies may be so remotely removed from the prime contractor that the identity of the prime contractor and these remote subcontractors is unknown to each other.

In many respects the problems facing subcontractors upon termination of war production will be identical with the problems that will confront prime contractors. The expansion in production and employment and the rearrangement of factories and facilities brought about by the war will make the task of conversion to commercial production difficult and troublesome. Even in the midst of war production some thought must be given to the effect and method of termination, and plans must be made so that the transition to peace will be as rapid and orderly as possible.

The various departments of the Government have endeavored to provide a basis for such planning, insofar as prime contractors are concerned, by termination clauses in procurement contracts which define the basis of settlement between the Govern-

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¹ This article was written considerably in advance of the introduction in Congress of the Murray-George Bill (S. 1718, 78th Cong., 1st Sess., Feb. 11, 1944) and the release of the "Baruch Report," in both of which developments there is observable a marked similarity to the views herein expressed as to policies concerning subcontractorship problems.

ment and the contractor in the event of termination. These clauses have been modified from time to time in an attempt to provide an adequate means of dealing with termination problems when they will arise. The Uniform Termination Article sponsored by Mr. Baruch and released through the Office of War Mobilization is the latest development in this program.

The great difficulty in attempting to handle the subcontractor's termination problems by contract lies, of course, in the fact that there is no contractual relationship between the Government and the subcontractor. The termination clauses provide, in substance, that the prime contractor will be reimbursed by the Government for expenditures incurred with the approval of the contracting officer in settling outstanding obligations in connection with the uncompleted portion of the prime contract. Neither the prime contractor nor the subcontractor has definite knowledge of the standards which will guide the contracting officer in determining whether he will approve or disapprove a subcontractor's claim.

Accordingly, many prime contractors will be hesitant to settle with subcontractors prior to approval by the contracting officer of the subcontractors' claims. In effect, this would place the subcontractor in the position of having the amount of his claim determined by a person who is not party to the contract. It is true that in the absence of an agreement to the contrary the subcontractor is not bound by the determination of the contracting officer and is entitled to look to his customer for payment. However, the right to look to the customer may be of little value if the customer is insolvent. In fact, the key to the weakness of the subcontractor's position upon termination of war contracts as contrasted with the position of the prime contractor lies in the fact that the subcontractor does not have the solvency of the Government behind the obligation to reimburse him for termination claims.

In an effort to meet the demands of war production thrown on American industry, billions of dollars worth of war orders have been accepted by subcontractors without hesitation and without the assurance of the solvency of their customers which prime contractors enjoy. It is extremely doubtful whether industry could have achieved the splendid results it has if subcontractors had adhered to sound, fundamental business rules which govern the normal conduct of their business. It is to the great credit of industry that it was willing to adopt this attitude. It is this attitude, however, which aggravates the problems facing the subcontractor on termination.

From a realistic viewpoint, the immediate and urgent problems confronting a subcontractor on termination are:

1. Will his claims in connection with terminated contracts be paid?
2. What will be the basis on which his claims are settled?
3. When will his claims be paid?

I. WILL SUBCONTRACTORS' CLAIMS IN CONNECTION WITH TERMINATED CONTRACTS BE PAID?

When a war production contract is terminated the general procedure is for the prime contractor, pursuant to the provisions of the termination clause in his contract, to terminate the first tier subcontracts chargeable to the contract. The first tier subcontractors, in turn, terminate their immediate subcontracts, and this process continues until the most remote subcontractor finally receives notice of termination.

The most remote subcontractor submits a claim for termination charges to his customer, who, in turn, submits his own claim, which embodies the amount of his subcontractor's claim, to his customer. This process continues until the prime contractor receives a claim from the first tier subcontractor embodying the claims of all of the remote subcontractors. This claim, together with the prime contractor's own claim, is submitted to the contracting officer for approval. If the claim as submitted by the prime contractor is in proper order, it will be paid by the Government to the prime contractor who should reimburse the first tier subcontractors.

Under this method of handling claims the most remote subcontractor will not receive payment until the money paid by the Government has been channeled through all of the various tiers of subcontractors. If any subcontractor in this chain should prove to be insolvent, the next subcontractor in line will not receive payment for his claim even though the ultimate customer, the Government, has paid the full amount of the claim. It is not difficult to foresee how such an event might precipitate a series of insolvencies which would prove disastrous to our economy.

It may be argued that this same risk is present in normal commercial business. The fundamental difference between the situation confronting subcontractors today and the situation in normal times is that usual credit precautions are now secondary to war production and in normal times industry does not have the possibility of the immediate cancellation of 75 to 100 billion dollars of business hanging over its head.

The Government may, in certain cases, protect the first tier subcontractors from loss resulting from insolvency of the prime contractor by escrow provisions or direct payments to such subcontractors, but such procedure will not remove the risk to remote subcontractors if the first tier or any of the intermediate tier subcontractors prove to be insolvent.

The right of the Government to cancel prime contracts for default also presents a certain amount of risk to all subcontractors. In the event of such cancellation the prime contractor is paid only for articles delivered, and may be charged with additional expense incurred by the Government in having the contract completed elsewhere. Under such circumstances the prime contractor may be unable to meet his obligations to his subcontractors.

To date, the risk to subcontractors of cancellation of prime contracts for default has been more theoretical than actual. The right of cancellation for default has been exercised very sparingly by the Government even where the contractors have been behind in deliveries. This attitude by the Government is a recognition of the many problems of material and labor procurement confronting industry in this vast war effort. This attitude on the part of the Government, plus the contract assurance contained in the new Uniform Termination Article that terminations at the end of the war will be handled under the "Termination for Convenience" clause rather than the "Default" clause unless the contractor's default is gross or wilful, materially reduces the subcontractor's hazards resulting from the "Default" clause.

Subcontractors have a very realistic problem in connection with the question of whether their claims relating to terminated contracts will be paid, and it is quite conceivable that their fears in this connection may lead to a more conservative policy in the matter of acceptance of additional subcontracts. Such a course is particularly likely as the war progresses and as businessmen give more thought to the problems of termination. It is possible that the adoption of a more conservative attitude may have an adverse effect on war production; therefore, it is imperative that a way be found to give subcontractors greater assurance that their claims in connection with terminated contracts will be paid regardless of the solvency of their customers. This assurance can probably be given only as a result of Congressional action.

2. WHAT WILL BE THE BASIS ON WHICH SUBCONTRACTORS' CLAIMS ARE SETTLED?

The purpose of termination clauses in prime contracts is to acquaint contractors with the basis of settlement of claims and to minimize the damages payable by the Government in the event of termination.

The major difference between what a contractor could claim for under the termination clauses and what he could claim for at common law is that at common law he could claim for the complete anticipated profit on the contract whereas the termination clauses limit him to a profit based in general on the work done to the date of termination.

While some prime contractors have included termination clauses in subcontracts which, in general, provide for termination on substantially the same basis that the prime contract can be terminated by the Government, probably a majority of subcontracts are handled on a purchase order basis and do not include a termination clause. Accordingly, many subcontractors will be faced with a choice of whether they will compute their claims in a manner consistent with that set forth in termination clauses in prime contracts or whether they will disregard the limitations contained in such termination clauses and endeavor to claim for the complete anticipated profit on the contract.

It would appear logical that contracting officers would be guided by the same standards of admissible and inadmissible costs and fairness of profit in approving subcontractors' claims as in approving prime contractors' claims. Since prime contractors will be reimbursed for claims paid to subcontractors only to the extent that such claims are approved by the contracting officers, any attempt by subcontractors to be reimbursed for costs or profits not allowable by contracting officers will be resisted by prime contractors.

Many companies occupy the dual position of a prime contractor and a subcontractor in their war business. It frequently occurs that a large company, engaged in manufacturing diversified products, occupies the position of a prime contractor and a subcontractor on the same contract. It would seem rather inconsistent for such a company to adopt one set of standards in computing its claim as a prime contractor and another set in computing its claim as a subcontractor.

Many prime contractors have taken the position that they will not pay subcontractors' claims until such claims have been approved by contracting officers and until the prime contractor has received payment therefor from the Government. Other prime contractors are making partial payments pending approval by the contracting officer, but require the subcontractor to agree to repay any amount by which the partial payment exceeds the amount of the claim as finally approved by the contracting officer.

Where prime contractors make partial payments in advance of approval by contracting officers they undoubtedly will endeavor to keep such payments within the amounts that they believe will be approved subsequently by the contracting officer. Attempts by subcontractors to recover more than would be recovered if their claims were computed in the manner provided in the Government termination clauses will act as a deterrent to voluntary partial payments by prime contractors, cause delays in the settlement of claims, and in many cases will result in time-consuming and costly litigation.

The argument that subcontractors should compute claims in the same manner as prime contractors could be made with much greater force if subcontractors enjoyed the same security in regard to the financial responsibility of their customers that prime contractors enjoy. In fact, a very convincing argument can be made that subcontractors should not forego their common law rights of settlement, due to the additional risk as to payment which they run. Such an argument should not be dismissed as specious. It is a fundamental rule of business that a company will be content with a smaller return where there is little if any risk involved. The answer to this argument must, therefore, lie in legislative enactment of a satisfactory plan for removing or minimizing this risk.

If subcontractors could be assured that they would be paid for their inventories and work in process together with expenses incident to termination, it would be easier to convince them that they should accept as profit an amount computed in

accordance with the termination clause in the prime contract rather than insist on the amount to which they might be entitled at common law.

In the event legislation is passed designed to expedite the settlement of subcontractors' claims, such legislation will probably specify the basis for the determination of claims. The Dent Act, passed after the last war and designed primarily to validate certain defective contracts, definitely prohibited recovery by contractors of anticipated or prospective profits.

3. WHEN WILL THE SUBCONTRACTORS' CLAIMS BE PAID?

For many subcontractors the question of when they will be paid upon termination of war contracts may be of more immediate importance than what they will be paid. The impact of general termination will be severe at best. For those companies that have all of their working capital tied up in war production the necessity for prompt payments or the availability of loans to supply working capital until claims are paid will be imperative. Probably the greatest single factor in preventing a postwar collapse will be the rate at which industry can effect conversion to peacetime production and absorb labor therein. To accomplish this conversion, capital must be available either through prompt payment of claims or through loans. It would be a shortsighted policy if the Government would take advantage of the urgent need of contractors for working capital in order to make inequitable settlement of claims.

A problem which is common to both prime contractors and subcontractors, but which has not received as much attention as the question of payments, is the method of disposing of inventories and work in process. Even if a company has working capital available it may be unable to resume peacetime production for lack of adequate manufacturing space until such time as disposition has been made of war inventories. As matters now stand, subcontractors are dependent upon their customers both for prompt payments and for disposition of inventories. Ultimate control over these matters, however, rests with the contracting officers.

The length of time required for payment and disposition of inventories will depend in a large measure on the manner in which a subcontractor calculates his claim. Undoubtedly, claims calculated in accordance with the manner provided in the termination clause of the prime contract will be disposed of more promptly than claims calculated on a basis of settlement more favorable to the subcontractor.

Many subcontractors as well as prime contractors have endeavored to finance their war production and to free their own working capital at the end of the war by Regulation "V" loans. Subcontractors who have not investigated the possibilities of Regulation "V" loans and more particularly the recently liberalized policy sometimes referred to as "VT" loans should do so at once.

Regulation "V," even in its modified form, does not eliminate the need for a well planned termination procedure and the need for legislation on the subject. How-

ever, many contractors have protected themselves against some of their postwar problems by taking advantage of Regulation "V" in such a way that will free all or substantially all of their own working capital immediately upon termination of contracts.

Regulation "V" loans generally provide for an assignment of receivables of the borrower under war production contracts. Such assignment provisions, when and if made effective, may offer very troublesome credit problems to subcontractors. The assignment of receivables to a bank by a prime contractor will place a subcontractor in a subordinate position for the collection of his accounts. The subcontractor may refuse to occupy such a subordinate position and insist upon making shipments on a C.O.D. basis. Before taking such a step, which may jeopardize future commercial transactions between the companies, the subcontractor must carefully evaluate the disadvantages to him of the operation of the assignment provision.

Partial payments by the Government or by a subcontractor's customer may help to relieve the subcontractor of some of his financial problems incident to termination. The effectiveness of such payments will depend on the speed with which they will be made. Under existing termination clauses in prime contracts considerable delay is apt to be encountered before the Government is in a position to make even partial payments.

CONCLUSION

The termination of the vast number of war production contracts in an orderly manner, and the prompt payment of claims thereunder, will require very close cooperation between contracting officers, prime contractors and subcontractors. The fact that, even before industry has reached the peak of its production, more contracts have been terminated than were terminated during and immediately following the last war is but an indication of the magnitude of the problem.

Interim terminations, while distracting at times, can afford the means of smoothing out termination procedures. Experience gained therefrom should be of great assistance in the preparation for handling the large number of terminations with which industry will be faced at the end of the war.

The development of organizations and personnel trained to handle the job by government and industry is of extreme importance. It has been estimated that termination claims will amount to 15% or 20% of the unfilled balance of terminated contracts. If we assume that the value of terminated contracts at the end of the war is from 75 to 100 billion dollars the magnitude of the task that confronts the Government and industry becomes apparent. For many companies, the settlement of claims will constitute their only source of income during the period of reconversion. A company that waits until the last minute to organize for this task is apt to find that its claims are among the last to be settled.

Of equal, if not greater importance, is the careful study and consideration necessary to insure a company that it has included all of the elements of cost in a claim that are properly attributable thereto. Many companies have organized special termination departments already, and are hard at work analyzing the termination problem from all angles in order to minimize the potential loss incident to terminations. The organizations of many subcontractors are too small to justify a separate termination department, but they are not too small to devote the same careful consideration to the preparation of termination claims that is given to the computation of costs in connection with the original sales. This work deserves and in many cases is receiving the consideration of top executives. Some companies, however, either because of the pressure of meeting delivery schedules or because they have not as yet experienced terminations, have given little thought to the problem.

While it is extremely important for contractors to include in claims all items of cost incurred or made with respect to the uncompleted portion of a terminated contract, it is also important, in the interest of speedy settlements, that claims be free from frivolous charges or padding. Attempts to pad claims in order to establish a trading position will result in delays in final settlement and may subject the contractor to charges of fraud.

Despite the improvements that have been made in the termination clauses used by the Government, satisfactory answers to subcontractor's problems as set forth herein have not been found. Since there is no contractual relationship between the Government and subcontractors, the solution to the problems undoubtedly will depend on legislation.

The bill recently introduced into the Senate by Senator Murray as well as the Baruch Report and the Report by the Senate Postwar Planning Committee offers considerable hope for a prompt and effective answer to the subcontractor's problems.

A suggestion which should receive careful consideration by Congress is a provision for mass or group settlement of contracts. There would appear to be no insurmountable difficulty in embracing in one settlement prime contracts with the War and Navy Departments and the Maritime Commission. Such a settlement procedure might be similar to overall renegotiation of profits. However, certain difficulties will arise in the application of such a procedure to subcontractors and particularly to the remote ones.

The chief obstacle in group settlements with remote subcontractors lies in the difficulty of identifying the subcontract with a particular prime contract. If a satisfactory solution to this problem could be found the plan for group settlements might materially expedite the termination program.

Direct dealings between subcontractors and the Government would provide a means of removing the fear now present with many subcontractors that the collection of their claims is dependent on the solvency of their customers, but the same

obstacle to group settlements of subcontracts is present in any plan whereby the Government would attempt to settle on an individual contract basis directly with subcontractors. In addition to the difficulty of contract identification, the work of a contracting officer would be multiplied many times if he attempted to deal individually with the great number of subcontractors.

However, it seems possible to relieve subcontractors of dependence on the financial position of their customers without the complications of group settlements or settlements directly with the Government. This could be done by providing that upon termination of a prime contract the contractor would be required to terminate subcontracts and to instruct subcontractors to include with claims filed a list showing the name and amount of the claim of each of their subcontractors. The prime contractor's claim when submitted to the contracting officer would be in two parts, one of which would be a claim for the amount due the prime contractor, and the other a claim for the amount due each individual subcontractor down to the most remote tier. After approval, the Government would make direct payment of the amount due the prime contractor and would pay the subcontractors through some escrow arrangement. In this way the money due any individual subcontractor would never pass into the hands of the prime contractor or of a subcontractor in a higher tier. Upon making such payments, the Government would acquire all rights to inventories and work in process that were the basis of the claim. Any partial payments made by prime contractors or subcontractors to other subcontractors could be taken care of by an assignment of claims to the extent of such payments.

Such an arrangement would have the advantage of freeing the subcontractor from dependence on the solvency of his customer for the payment of his claim. If this could be accomplished, the outstanding disadvantage of the position of a subcontractor in relation to the position of a prime contractor would be removed.

In addition, the contracting officer would be relieved of the tremendous task of dealing individually with the vast number of subcontracts and the difficulties of identification of subcontractors' claims with prime contracts and appropriations. The contracting officer would also have the assurance that the claim of each subcontractor had been reviewed by the customer. While the customer should not have to warrant the accuracy of the subcontractor's claim, it would seem equitable to require a certification by the customer that he had reviewed the claim of the subcontractor and that such claim seemed reasonable in amount. Each subcontractor, in submitting his claim, would be required to furnish supporting data in sufficient detail to permit a careful analysis of the claim and would be required to certify as to the accuracy of the claim. Before final disallowance of items in a subcontractor's claim by a contracting officer the subcontractor should be afforded an opportunity to submit data in support of such items directly to the contracting officer.

The settlement of claims could be materially accelerated if contracting officers could be relieved of the responsibility of checking small claims. If claims of both prime contractors and subcontractors that are not in excess of a certain dollar amount could be paid without question, unless they are obviously erroneous or fictitious, a large amount of detail work could be eliminated. Such a policy would make it possible for prime contractors and the higher tier subcontractors to pay their suppliers up to the specified amount without question of reimbursement.

To facilitate partial payments in order to free working capital for postwar requirements, claims could first be filed on an estimated basis and contracting officers could be authorized or required to pay promptly a certain percentage of such estimated claims.

Undoubtedly, if legislation is enacted which would have the general effect of a guarantee by the Government of payment of subcontractors' claims, certain limitations on the composition of such claims would be necessary. It would be highly inconsistent for the Government to pay subcontractors on a more liberal basis than that used in the payment of prime contractors. If subcontractors could be assured that in the event of termination they would recover within a reasonable time, and without regard to the solvency of their customers, all costs incurred or incident to the terminated contract plus a reasonable profit thereon, it would seem reasonable to expect them to forego such additional benefits such as anticipated profits which they might recover at common law.

The administrative job of handling the termination of 75 to 100 billion dollars of contracts at the end of the war will be so vast that any plan evolved for the settlement of claims will undoubtedly entail a certain amount of time. Payrolls, during this period, cannot be paid out of claims but must be paid with cash. Accordingly, there will be a very serious need for some method of financing, pending settlement of claims. A step in this direction has been taken by the availability of the "VT" loans. The number of companies that have already taken advantage of "V" and "VT" loans is not very large compared with the number of companies that will be seriously crippled if they are forced to wait for the payment of their claims.

There are undoubtedly several reasons why "V" and "VT" loans have not been used more extensively. Some companies are indifferent to and others unaware of the problems that will confront them with overall termination. It may be, also, that the "V" loan procedure is too complicated for many companies. Possibly many companies are unable to meet the tightening requirements of "V" loans.

Whatever the reasons may be, the economic welfare of the country will require some simple, speedy and adequate method of financing prime contractors and subcontractors for the period between termination of contracts and payment of claims. To the extent that such a method of financing is available, the demand for a speedy determination of claims is eased. Financing should not be used as an excuse for

dilatory settlement of claims but it can be used as a means of effecting an orderly procedure.

The method and time required for the settlement of claims will largely depend on whether it is considered in the best interests of the country to adjust each claim to the last penny or to effect reasonably accurate settlements in a minimum amount of time. No thinking person wishes to see the raid on the United States Treasury that a "blank check" policy in the settlement of claims might produce. On the other hand, it is vitally important to avoid the stagnation that would be produced if industry were unable to go forward with peacetime production because its working capital was tied up in claims against the Government which could only be settled after detailed audits and examination.

Somewhere between the "blank check" policy and the detailed audit policy lies a middle road which Congress should seek to find through proper legislation. The net cost to the taxpayers of a reasonably liberal and speedy program for settling claims would undoubtedly be far less than the cost of caring for a vast army of unemployed which certainly will result from a penny-pinching policy.