

# COMPANY SETTLEMENTS

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One of the most interesting developments which has come out of Congressional hearings and the Baruch investigation of termination problems is the proposal for company settlement. Advocates speculate upon its many enticing advantages, but many administrative difficulties are involved which must be overcome. Arguments for the scheme are that it will speed up payment for both prime contractors and subcontractors, at the same time offering the possibility of better coordination of termination and renegotiation procedures. Company settlements are not possible under existing law and legislation authorizing use of the device is necessary.

At the present time the entire matter is more or less subject to debate within administrative and Congressional circles. On February 11, 1944, Senators Murray and George introduced a bill (S. 1718) in the Senate which expressly authorized use of the company settlement device. This is the first comprehensive termination proposal which has been made—it covers every phase of the problem—and enactment is probable. Though some modifications may be made in other provisions, the sections dealing with company settlement undoubtedly will stand. Subsequently, on February 17th, Mr. Baruch submitted his report on War and Post War Adjustment to the President and Mr. Byrnes. This so-called "Baruch-Hancock" Report, likewise, advocates company settlements. While recognizing the administrative difficulties involved, it recommends legislation authorizing company settlements and presses the procurement agencies to experiment with the device so as to put it on a practical basis.

## WHAT IS A COMPANY SETTLEMENT?

*Company settlements would streamline procedure.* Instead of the present relay process with responsibility passing from the government to the prime contractor and so on down the line to the farthest removed subcontractor, the government would deal directly with each war producer whether prime contractor, subcontractor, or sub-subcontractor. Legal fictions such as "privity" of contract would be ignored and the matter treated on a realistic overall basis similar to that used on renegotiation.

The company settlement device might be applied in the following manner.

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If *all* a war producer's prime and subcontracts are totally terminated, Uncle Sam simply might ask him to provide a statement of the *total actual cost of all contracts*. This total actual cost would then be compared with the *total* of the various contract *prices*, the *total* of the costs *estimated* when the various contracts were made, and the total *anticipated* profit if all the contracts were completed. In the light of these factors, an overall lump sum settlement could be agreed upon, or reached by one of the formulas about to be discussed.

Company settlements could be used even if some of a producer's contracts or subcontracts are continued. Difficulty may be encountered, however: (a) if the terminations are not simultaneous; or (b) if individual contracts are only partially terminated; or (c) if a sub-subcontract is so far removed that it cannot be traced to a government prime contract. In any of these situations, the down-the-chain method may be preferable, depending upon the situation.

Terminations made during the war, for the most part, have been to readjust production programs to meet changing military needs and seldom involve complete termination of all contracts and subcontracts. If only a portion of a producer's prime contracts and subcontracts are totally cancelled, this portion could be grouped and an over-all settlement reached. A snag may develop, however, unless these prime and subcontract terminations occur at approximately the same time. Improved timing may be expected as procurement agencies gain more experience in administering termination. Cutbacks in production are planned in advance and consequently, in most cases, specified contracts and subcontracts could be scheduled for cancellation simultaneously. Pre-termination conferences with contractors would be a valuable aid in preparing these schedules.

Even two or more contracts which are partially terminated might be grouped in some cases, but here it would obviously be more difficult, if not impossible, to apply the company method. However, it could be applied without difficulty to totally terminated subcontracts even though the prime contract or intermediate subcontract is partially terminated.

Whenever scheduling and simultaneous termination are impracticable for any reason, contracts and subcontracts could be (1) grouped conveniently, or (2) handled separately with the government dealing directly with subcontractors, as well as the prime contractor or (3) cancelled by the down-the-chain method. Only the men handling the case can make the decision, since the choice must necessarily depend upon the facts of each case.

Subcontracts which cannot be traced directly back to government work constitute the one situation in which use of the company basis of settlement will be impossible even to a limited extent. The down-the-chain method is the only way these cases could be handled.

#### ARE THEY NECESSARY?

*Flaws in existing procedure.* Small business is the 1944 version of the "forgotten man." Those small firms which succeeded in obtaining war work may

receive a hard blow on termination. Subcontractors and suppliers are rightfully worried about termination. While prime contractors often suffer delayed payment, they are assured of ultimate payment, dealing as they do directly with the government. Subcontractors not only run a greater risk of delay but also shoulder the added hazard of nonpayment. Under present "down-the-chain" settlement procedures, subcontractors face the double-barreled threat that prime contractors or intermediate subcontractors may become insolvent or delay settlement for selfish reasons. Starting with first tier subcontractors, this insecurity increases for each succeeding tier in direct proportion to the degree of removal from the prime contractor, since more people interpose between the subcontractor and the government.

The crux of the subcontractor problem is the present down-the-chain method of handling termination. Prime contracts are terminated by the government, but it has no direct relationship with subcontractors and sub-subcontractors. While the termination notice directs the prime contractor to terminate all or specified subcontracts depending upon whether the contract is totally or partially terminated, the actual termination is left to the prime contractor. It is his duty to notify subcontractors and effect a settlement with them. The government's only interest is by way of a check on prime contractors who are required to obtain approval of subcontract settlement proposals from the contracting officer. Likewise, the prime contractor has no direct contact with sub-subcontractors. The termination and settlement are effected by the subcontractor at the direction of and subject to the approval of the prime contractor. This procedure goes on ad infinitum down to the very lowest tier of sub-subcontractors.

To relay responsibility in this manner can only serve to pyramid delays. As a result, two serious threats inherent in delay are accentuated. These dangers are: (a) Bankruptcy of small subcontractors if prime contractors pass the burden on by withholding payment; and (b) receiverships for financially weak prime contractors as a result of suits by subcontractors.

If payment to the prime contractor is not made promptly, prime contractors probably will withhold payment from subcontractors who in turn will tell sub-subcontractors that they cannot be paid. Thus the burden will be passed down the line until it finally gets to the last firm in the chain. The financially weakest link in the chain may be unable to stand the pressure for more than a few weeks. When this firm goes under, a receiver will be appointed and will bring action against the previous link in the chain, thus perhaps forcing that firm into bankruptcy, and starting the reverse process up the line until the prime contractor is hit. At the same time, the financial pressure on subcontractors in lower tiers is increased and additional insolvencies may develop there also.

Bank loans are no solution since no bank would accept a subcontractor's claim as collateral in the absence of government guarantee for two very good reasons: (a) the subcontractor's claim is indefinite and uncertain; and (b) when, as, and if determined, it is subject to offsets which the prime contractor may have against

the subcontractor by reason of other contracts or other causes of action as well as the particular contract.

This situation can be relieved only by devising some procedure such as "company" settlements by which subcontractors can deal directly with the government.

#### SHOULD LEGISLATION BE MANDATORY?

*Company settlements should merely complement down-the-chain settlements.* To say that "company settlements" should be authorized does not mean that "down-the-chain" settlements should be forbidden. Both Congressional and administrative circles are of the opinion that legislation should merely authorize use of the company basis as an alternative to the down-the-chain method. The nature of the problem forbids any statutory direction that the company basis be applied. Use must be discretionary with the services and flexibility in procedure assured.

Procurement agencies should be free to take any steps which are considered necessary in the public interest. When and how the company basis of settlement is to be used is for them to decide. Likewise, the form and contents of the contractor's statements, as well as the extent of the government audit, should be decided by the procurement agency.

In many situations, the company settlement will be impracticable. Consequently, the down-the-chain method also must be available. Furthermore, while many officials of the procurement agencies favor company settlements, the majority are opposed. To force the method upon procurement agencies would be unwise. They are not ready to administer it. Statutory authorization should be on the books and waiting, however, when the agencies awaken to the advantages offered.

#### CAN FORMULAS BE APPLIED?

*Formulas may require a modification.* Every termination clause contains a formula or so-called "court" provision to be applied in computing the settlement in the event an agreement cannot be negotiated. These formulas have another very important function in that they act as a guide for the contracting officer in arriving at the amount of a negotiated settlement.

Formulas used in Army fixed-price construction contracts can be applied to company settlements with no difficulty since computation of the amount to be paid the contractor is placed on a straight cost-plus-a-reasonable-profit basis—reasonable profit being determined by the ratio which the actual cost bears to total estimated cost. Fixed-price supply contracts present an entirely different situation, however. The Baruch uniform clause continues the distinction between completed and uncompleted portions of the work made in earlier Army and Navy clauses, and further complicates the situation by breaking the uncompleted portion down into work in process and unprocessed inventory. Contractors are paid for completed work at the unit price stated in the contract, narrowing the computation down to the uncompleted portion. In figuring the profit on the uncompleted portion,

two different profit rates are applied—one to the cost of work in process and the other to the cost of unprocessed inventory.

Cost accounting is very complicated under these formulas. All require that cost be apportioned between civilian and government work. When this allocation is made, the total amount assigned to the government work must again be broken down and charged specifically to the various government contracts. Then the cost of each contract must be distributed between completed and uncompleted portions of the contract. Finally, under the Baruch uniform clause, the contractor must again break down the cost of the uncompleted portion so as to allocate it to work in process and unprocessed inventory. In many cases such a minute cost breakdown is so involved that computation is impossible or the result of such a general approximation as to be of little value. Direct costs present no problem, but the allocation of indirect costs such as overhead and fixed charges portend nightmares for the accountant.

Even under straight down-the-chain settlement, this cost segregation involves accounting difficulties for the contractor. These accounting problems inherent in existing formulas will be accentuated if the company settlement is adopted. When settling single contracts on a down-the-chain basis, accountants may struggle through, but if the same distinctions are applied to company settlements it is almost certain that compliance with the formula will be so difficult as to be virtually impossible. Consequently, if company terminations are adopted formulas may have to be modified so as to be adaptable to both the termination of single contracts and overall termination of all contracts on a company basis.

This would best be accomplished by placing the formula on a total cost plus either a "reasonable" or a "fixed-percentage-of-profit" basis. Either formula would abolish the existing distinction made in fixed-price supply contracts between completed and uncompleted work. With this modification adjusted profit might be computed either on a fixed percentage basis similar to the Baruch clause or the "reasonable" basis used in Army construction contracts. The fixed percentage basis would be more simple but less equitable. By this method the adjusted profit would be computed by applying a fixed rate to total costs. While the "reasonable" basis would be a bit more complicated, it would be more equitable. Adjusted profit might be computed by multiplying the total anticipated profit, if the work were completed, by the total actual cost over the total cost as estimated when the contract was made.

Safeguards would have to be taken to avoid excessive payment. As under existing formulas, subcontract claims, unprocessed inventory costs, salvage credits, and post-termination expenses would have to be excluded in computing profit. Settlements, moreover, might be subject to renegotiation unless specifically exempt for some reason.

These formulas offer definite advantages over existing negotiated and formula settlements. Both do away with the distinction now made between completed and

uncompleted portions of the contract and consequently are equally adaptable to company or down-the-chain settlements. When combined with adequate contractual definitions of cost, furthermore, they make possible an effective audit for fraud by the Comptroller General and the Attorney General. If termination legislation restricts activities of the Comptroller General to the investigation of fraud and conformance with Congressional appropriations, the need for the negotiated settlement device would cease. All settlements, whether on a company or down-the-chain single contract basis, could be by formula. Thus the element of uncertainty would be removed permitting contractors to estimate the amount of the settlement fairly accurately in advance. An indirect effect would be to facilitate post-war financing.

#### ADVANTAGES OF THE PLAN

Company settlements offer three definite advantages over the down-the-chain method: (a) by negotiating directly with sub and sub-subcontractors, the company basis would slash the delay implicit in the down-the-chain method of relaying terminations from the government to the prime contractor and then through him to his subcontractors who again pass it on to sub-subcontractors and so on to the lowest tier of sub-subcontractors; (b) by grouping all prime and subcontracts held by a company, there would be a single audit, dispensing with existing duplication; and (c) company settlements would permit better coordination between terminations and profit renegotiation proceedings of Price Adjustment Boards.

*Minimizing delays.* At the very start of this article, it was shown how company settlements might speed up settlement procedures and thus hasten payment for both prime and subcontractors. Consequently, there is no need to retrace this ground at this point. Below discussed are the two additional advantages—the single audit and coordination of termination and renegotiation.

*Company settlements would simplify accounting and audits.* Under the down-the-chain method, there is great duplication in auditing contracts. This will become more apparent as the load of terminations increases. Prime contractors will be faced with a separate settlement and audit on every terminated contract. The situation will be even more impossible for subcontractors who may have a different prime, sub or sub-subcontractor to deal with on every termination. Company settlements would reduce the accounting problem and remove the confusion which is bound to arise if the producer must negotiate with the government on his prime contracts, and with a large number of prime contractors and intermediate subcontractors on his subcontracts.

*Company settlements would permit better coordination with renegotiation.* In the heat of the dispute between the procurement agencies and the Comptroller General over control of termination settlements, there is danger that sight may be lost of the impact of renegotiation on business. Emphasis has been placed on the fact that termination settlements negotiated by procurement agencies must be final, conclusive and expeditious since banks and investment houses will be reluctant to lend

money or float new securities if the General Accounting Office has power to upset negotiated termination settlements on subsequent audit.

If post-war renegotiation hangs over the head of business, it too may cause such a situation. Not only will questions be raised concerning termination status, but also renegotiation status. The industrialist applying for a loan or floating new securities may be confronted with three questions: (a) Have you received payment of your termination claims? (b) Has the settlement been fully cleared by the General Accounting Office? and (c) Have you received profit clearance from Price Adjustment Boards? Even though the termination settlement has been fully cleared as final and conclusive, bankers and investment houses may not want to be involved if renegotiation is up in the air.

Coordination of the functions of Price Adjustment Boards with those of terminating agencies is the best solution for this situation. Fundamentally, the problem faced on termination is the same as on renegotiation—the determination of a fair profit. Unification or close coordination would be ideal from the standpoint of both government and contractor since it would avoid duplication of work. If all contracts held by a contractor were terminated, renegotiation and settlement could be effected at once and the contractor exempted from future renegotiation.

Terminations made during war time are a hitch since some contracts may be fully terminated while others are continued in whole or in part. This is not an impassable obstacle, however. If only a part of a firm's contracts are terminated, cost reimbursement could be made in full and the question of profit left to the end of the fiscal period when renegotiation is effected. At that time final settlement could be negotiated crediting cost and profit payments previously made. Thus terminations could be treated as part of the overall renegotiation and a square deal assured both contractors and the government.

Procedural and administrative problems are the major obstacles to coordination or unification. Both termination and renegotiation involve the determination of fair profit, but the procedures followed are so diametrically opposed that even coordination, not to mention unification, is almost impossible. Renegotiation crosses contract lines and consolidates a firm's prime contracts, subcontracts and sub-subcontracts of every tier, treating them on an overall company basis as one contract. Contrastingly, contract terminations presently are conducted by the down-the-chain method. While termination regulations permit consolidation and grouping of prime contracts, this does not apply to subcontracts. Terminations pass from hand to hand, so to speak, from the government to the prime contractor, fanning out from him to subcontractors and then to sub-subcontractors down the contract chain to the lowest tier of sub-subcontractors.

This conflict in procedure obviously makes unification impossible. Even if termination and renegotiation are kept separate, coordination of the two is more difficult than it would be if terminations were conducted on a company basis.

Other administrative problems connected with unification are comparatively

simple. Personnel of Price Adjustment Boards would have to be expanded but the Boards possess valuable pricing information which would assist them in effecting a settlement. In any such setup, contracting officers would have to be assigned a subordinate role. As is now the case with renegotiation, their advice and assistance would be of great importance in working out an equitable settlement but they lack the broad knowledge of pricing necessary to negotiate a company settlement.

Mandatory legislation would be unwise here for precisely the same reasons as in the case of the company settlement itself. This question of unification or coordination of termination with renegotiation is one for the procurement services to solve. Legislation should merely make unification possible by authorizing company settlements.

#### ADMINISTRATIVE OBSTACLES TO BE OVERCOME

*Nature of obstacles.* Analysis of the arguments against company settlements shows not one to be a real bar to the device. Each of these tenuous arguments centers on either a legal or administrative obstacle. Although complex, each has a solution. Opposition centers on five major arguments: (1) since no contractual relationship exists between the government and subcontractors, the government has no right to deal directly with them; (2) the government would act at its peril with subcontractors; (3) the device might result in duplicative payments to prime and subcontractors; (4) difficulty will be encountered in establishing that lower tier subcontracts and purchase orders are government work; and (5) the company settlement will not work in every case.

*No contractual relationship exists between subcontractors and the government—* their relationship is solely with the prime contractor or intermediate subcontractor with whom they do business. This objection is based entirely upon a legal fiction—that of “contractual privity.” By “privity,” lawyers mean the existence of a contractual relationship between two parties. This fiction grew up in defining rights and dealing out justice between contracting individuals. Since human beings like to think in terms of logic and past experience, it has come to be applied to contractual relationship between the government and individuals.

Such a legal technicality should not be permitted to obstruct company settlements. Inequities between contracting individuals were long ago overcome by super-imposing even more technical fictions such as implied or quasi contracts, and third party beneficiary. Properly phrased clauses in government prime and subcontracts can meet this new need and at the same time preserve the doctrine of privity. These clauses should provide for immediate assumption of subcontractor and sub-subcontractor claims by the government with prime and subcontractors obligated to assign rights and obligations to the government. Neither prime nor subcontract clauses need be statutory for they would come within a general legislative authorization of company settlements, but complementary legislation is necessary to protect the government against duplication in payments by reason of offsets

and insolvencies (see below). The government could then withhold any and all subcontract claims from the prime or intermediate subcontract settlement under consideration.

*Difficulty is foreseen in connection with offsets* which prime contractors may have against subcontractors and which subcontractors may have against sub-subcontractors, etc. Under present law, the government would act at its peril in making payment directly to a subcontractor. The necessity for communicating with each prime or intermediate subcontractor to determine possible offsets could be avoided at the same time adequately protecting offsets possessed by prime contractors and intermediate subcontractors by providing them with the right to file a statutory lien against any settlement made. Opponents may say that funds will be tied up by such a lien but this is an even more serious threat under present procedure. Now the prime contractor or intermediate subcontractor can simply withhold the amount of the offset and tell the lower tier subcontractor to sue.

*Duplicative payments may be made by the government.* Opponents argue that duplication may occur: (1) if the government has an offset against the prime contractor; or (2) if the prime or an intermediate subcontractor has an offset against a lower tier subcontractor; or (3) if the prime or intermediate subcontractor is insolvent. This probably is the most emphasized argument against company settlements. By speeding up settlements, however, company settlements would defeat the argument by reducing the possibility of duplication. Quicker settlements would diminish the number of bankruptcies and this in turn would reduce the cases in which offsets could not be recovered.

Effective safeguards could be taken, nevertheless, to avoid such duplication. If the government has an offset against a prime contractor, the amount could be deducted from the prime contractor's claim. In the event this amount totals more than his claim, then the contractor would make a cash payment to the government or the government would refuse to accept assignment of his subcontracts. If the government had to refuse the assignment, the contractor's name and a description of his contracts could be circulated among terminating officials so as to prevent inclusion of any subcontract claims traceable to the prime contractor in making company settlements with subcontractors. Special treatment could be given these cases since they would be comparatively few in number.

No duplication in payment could result from offsets held by prime and subcontractors against lower tier subcontractors. Even the most superficial audit of a subcontractor's settlement proposal would include writing to prime or higher tier subcontractors for a statement of any advances, partial payments or other offsets. Furthermore, such offsets would be protected by the statutory lien discussed above. Failure to file notice of lien would place any loss resulting from payment to the subcontractor on the shoulders of the prime or intermediate subcontractor guilty of the omission.

Likewise, no duplication would result from insolvency of the prime or an inter-

mediate subcontractor if a statutory trust is established over funds due sub and sub-subcontractors to supplement clauses requiring assignment of subcontract obligations and rights to the government. The trustee in bankruptcy could claim only the amount due the insolvent prime or subcontractor on his personal claim. Derivative subcontractors would be creditors of the government and not the bankrupt estate. A number of states now have laws of this type to protect subcontractors on public and private construction work.

If desirable, a final safeguard could be provided against duplications in payments. While the company settlement itself would be based on total actual cost as compared with total estimated cost and total anticipated profit, as stated early in this article, more extensive supporting statements might be required so as to make possible a comprehensive check at any subcontract level. Careful planning is necessary, but roughly these supporting statements might be of the following nature.

Contractors filing a company settlement proposal could be required to list all contracts, subcontracts and sub-subcontracts held by the claimant showing in connection with each (1) the price; (2) the amount of the contractor's "company" claim apportioned to it; (3) the price of each sub and sub-subcontract outstanding thereunder; and (4) the amount of each sub or sub-subcontractor's settlement proposal. In addition to his own, he would have to file cost statements and settlement proposals of each subcontractor showing similar information.

Thus any sub or sub-subcontract contained in the company settlement proposal could be checked back against the prime contract from which derived. This verification would not only make fraud difficult on any level but also would permit the rough check against excessive payment suggested by Mr. Collins of the Reliance Electric Company in his testimony before the Murray Committee. If a prime contractor's own claim plus those of his subcontractors total more than the prime contract price, something obviously would be wrong, making a more detailed check necessary. This test would be possible on sub and sub-subcontracts also.

Also to be considered is the government's duty to subcontractors. Prior to the war emergency, payment bonds were required from prime contractors so as to protect subcontractors, materialmen and laborers. Business capital has been strained in turning out the tremendous production demanded by a government at war. Consequently, surety companies were reluctant to carry the risk. Because of this, the requirement that payment bonds be posted was abolished. At the same time, pressure was brought on subcontractors to accept subcontracts regardless of the financial reliability of the prime contractor or intermediate subcontractor who placed the order. In the light of this, the possibility that there may be some duplication in payment by reason of insolvency would not seem to be a weighty argument against company settlements.

*Determination that lower tier subcontracts and purchase orders are in fact government work may be impossible*—the further a subcontractor is removed from the government, the more difficult this will be to determine. Unquestionably it

will be impossible to trace many remote subcontracts to a government prime contract, but this is no bar to company settlements since these subcontracts can be handled by the down-the-chain method. Legislative authorization of company settlements does not mean abolition of down-the-chain procedures. The two can exist side by side, the one complementing the other. Lower tier subcontractors and suppliers who cannot trace their end product to government work would probably receive quicker settlement even though the termination is handled on a down-the-chain basis, since higher tier contractors for whom the company basis is more practical would have their settlements speeded up and as a consequence could pay subcontractors and suppliers more quickly.

*The company basis may be impractical* if: (1) terminations are not simultaneous; or (2) individual contracts are only partially terminated; or (3) sub-subcontracts are so far removed as not to be traceable to a government prime contract. This objection has been discussed previously. Obviously, post-war terminations involve none of these situations. All three are commonly encountered, however, in terminating contracts during the war. The fact that war-time terminations are often partial is no serious obstacle since the down-the-chain method can be used insofar as the company basis is impracticable. Company settlements may be the more practical method even during the war in many situations. For example, it could be applied to totally terminated subcontracts even though the prime contract is only partially terminated.

#### ARE COMPANY SETTLEMENTS WORKABLE?

*Obstacles can be overcome.* Not one opponent of company settlement argues that it would not be preferable to the down-the-chain method if the administrative and legal problems could be solved. Every argument against the device has its foundation either in existing law or in present procedure. Legal technicalities should not bar company settlements if a more expeditious settlement can be achieved by that method. Law is a living thing which has evolved and changed throughout history to meet business needs. Likewise the necessity of changing existing administrative organization should be no obstacle. That is why we have administrators—to plan administrative organization and to improve it.