

Cost-Plus-a-Percentage-of-Cost System of Contracting

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the existing rate structure to be revised upward. This clearly permits the carrier to make use of released rates as a means of escaping liability for the consequences of its negligence in direct contravention of the avowed declarations of the Commission in *In Re Released Rates*.⁵¹ This condition prevails because as an administrative matter, the subject of limitation of liability under released rates authority is separate from the subject of the reasonableness *per se* of the rates involved. Unless existing rates are held in force by outstanding orders of the Commission, carriers are free, by filing tariffs with the Commission in accordance with Section 6 of the Act, to initiate such changes in the measure of those rates as they consider that they are prepared to justify.⁵² Orders granting released rates authority do not constitute approval of the measure of rates filed pursuant to the released rate authority.⁵³ Such rates, or any changes therein, are subject, as in the case of any proposed changes in unreleased rates, to protest and suspension under the provisions of Section 15(7) of the Act.⁵⁴ Clearly, this procedure should be amended in order to compel the carrier to set forth and justify its proposed rates at the very time that it applies for a released rate order. Also, any subsequent change of rates should be considered by the Commission before publication with reference to the previously obtained release rate authority.

ANTHONY J. DIMINO.

COST-PLUS-A-PERCENTAGE-OF-COST SYSTEM OF CONTRACTING

During World War I, the Government made extensive use of the cost-plus-a-percentage-of-cost system of contracting as a means of inducing contractors who lacked production experience to accept orders for manufacturing new types of war material. The results attained vindicated the use of this system as a means for rapidly increasing production; however, from a financial viewpoint, the resulting costs were excessive.

Under the cost-plus-a-percentage-of-cost (hereinafter referred to as CPPC) contracts, the fee or profit of the contractor is dependent on the cost of the work; the amount of the fee automatically adjusts itself to variations in costs resulting from changing conditions and requirements during performance. Thus, under a CPPC contract providing for a profit of 7%, if the costs amounted to \$100,000, the

⁵¹ See note 6 *supra*.

⁵² See U. S. C. A. tit. 49.

⁵³ A typical released rate order (No. 1077, dated May 6, 1944) states in part, "The Commission does not hereby approve the lawfulness, except under Sections 20(11) and 219 of the Interstate Commerce Act, of any rates which may be filed under this authority."

⁵⁴ See U. S. C. A. tit. 49.

contractor would earn a profit of \$7,000. However, if the costs were increased to \$150,000 his profit under the contract would amount to \$10,500. It is self-evident that under this class of contracts, it is to the contractor's financial interest to have the cost of the work run high. In practice, it was found there was no incentive to the contractor to reduce costs other than the contractor's personal satisfaction in doing a job well or as a possible means for enhancing his reputation.

In order to remedy this defect, the Government developed the cost-plus-a-fixed-fee (hereinafter referred to as CFFF) contract. Although both types of contracts are similar in that they guarantee reimbursement for all necessary and reasonable costs incurred in the performance of the work, the two types differ materially in the computation of the profit. Under the CFFF type of contract, the fee is set in advance based on a percentage of the estimated cost of performance. The fee is, therefore, not affected by variations in actual costs, but only by changes in the scope of the work. Inasmuch as the fee for each CFFF contract is fixed, it is to the contractor's advantage to prosecute the work efficiently so as to be in a position to undertake additional contracts.

At the start of the present emergency, Congress officially recognized the inherent defect in the CFFF system of contracting and, for the first time, took steps to prevent its further use by the Government.

Beginning with the Act of June 28, 1940,¹ which extended the authority of the Secretary of Navy by permitting the negotiation of contracts for the acquisition and repair of naval vessels and aircraft, Congress provided that "The cost-plus-a-percentage-of-cost system of contracting shall not be used under the authority granted by this paragraph to negotiate contracts."

In the Act of July 2, 1940,² which authorized the Secretary of War to negotiate contracts for necessary Army defense facilities, Congress provided that "The cost-plus-a-percentage-of-cost system of contracting shall not be used under this section."

Similarly in the Act of May 2, 1941,³ which authorized the U. S. Maritime Commission to negotiate contracts, Congress provided that "The cost-plus-a-percentage-of-cost system of contracting shall not be used under the authority to negotiate contracts granted by subsection (a) hereof."

After the outbreak of World War II, the First War Powers Act⁴ was passed. This Act in extending the emergency powers of the President contained a limitation which provided that "Nothing herein shall be construed to authorize the use of the cost-plus-a-percentage-of-cost system of contracting."

¹ 54 STAT. 676, 50 U. S. C. A. § 1152 (1940).

² 54 STAT. 712, 50 U. S. C. A. § 1171 (1940).

³ 55 STAT. 148, 50 U. S. C. A. § 1261 (1941).

⁴ 55 STAT. 839, 50 U. S. C. A. § 611 (1941).

The President's emergency powers were further extended by the Second War Powers Act,⁵ which also contained a similar limitation which stated that "The cost-plus-a-percentage-of-cost system of contracting shall not be used under the authority granted by this paragraph to negotiate contracts."

In accordance with the provisions of these statutes, Government contracting agencies discontinued the letting of prime contracts on a CPPC basis.⁶ However, prior to 1942, no regulations were issued by the Government contracting agencies applying this limitation to subcontracts entered into by Government prime contractors and, therefore, many prime contractors entered into subcontracts on a CPPC basis when such basis was deemed reasonable and necessary under the particular circumstances. This was especially true in the building construction field, where the CPPC system of contracting was a customary commercial practice.

The question as to whether the inhibition upon the Government contracting agencies in entering into contracts on a CPPC basis applied to subcontracts was first raised March 13, 1942 by the Comptroller General's Decision B-23293.⁷ The War Department, under the authority granted by the Act of July 2, 1940, entered into a CPFF prime contract with Day and Zimmerman, Inc., a building contractor. The latter entered into a cost-plus-a-percentage-of-cost subcontract, amounting to \$150,194.19, with the Western-Electro-Mechanical Co., Inc. The Comptroller General ruled that subcontracts on a cost-plus-a-percentage-of-cost basis were in contravention of the spirit and purpose of the Act of July 2, 1940. He stated that it was evident that the prohibition against this form of contracting could be substantially evaded and the purposes thereof defeated, were it not applied to the performance of that part of the contract work sublet by the prime contractors. It was therefore ruled that since the subcontract provided for payment on a CPPC basis, such agreement could not be regarded as creating any binding obligation on the Government to reimburse the prime contractor for any payments made to the subcontractor.

This case was resubmitted to the Comptroller General for permission to settle the claim on a *quantum meruit* basis. The Comptroller General, in Decision B-23293, dated February 11, 1943,⁸ denied the claim, stating that the CPPC subcontract made the contract unenforceable, and that no contract may be implied where a statute positively prohibits the transaction. The opinion points out that what

⁵ 56 STAT. 176, 50 U. S. C. A. § 633 (1942).

⁶ On December 27, 1941, the President of the United States, by Executive Order No. 9001, delegated to the War Department, the Navy Department, and the United States Maritime Commission, the authority conferred upon him by the First War Powers Act, with the limitation that "Nothing herein shall be construed to authorize the cost-plus-a-percentage-of-cost system of contracting."

⁷ 21 COMP. GEN. 858 (1942).

⁸ 22 COMP. GEN. 784 (1943).

Congress provided against was not merely a CPPC contract, but a "cost-plus-a-percentage-of-cost system of contracting". It was therefore concluded that the United States is neither bound nor estopped by acts of officers or agents in entering into, approving, or purporting to authorize agreements prohibited by law, even though it appears that the Government may have benefited thereby; and general principles of equity will not be applied to frustrate the purpose of such laws or to thwart public policy.

To date, the question of whether the inhibitions against the use of the CPPC system of contracting by Government contracting officers apply to subcontracts entered into by prime contractors has not been decided by the courts. It is the opinion of the writer, however, that when the question is judicially decided, the Comptroller General's ruling will be reversed.

The various statutes in point refer only to the extent of the authority of Government contracting officers and are without reference to the second party prime contractor or the third party subcontractor. When a subcontract is entered into by the latter two parties, the Government does not thereby become a prime party to the subcontract. The Comptroller General's decision is apparently based upon the assumption that a prime contractor is in the nature of an agent of the Government and that an inhibition upon a Government contracting officer would therefore apply to the prime contractor. However, there is ample authority to disprove any such relationship. The Supreme Court of the United States has ruled that a prime contractor is an independent contractor and is not an agent of the Government.⁹ In view of the Supreme Court's decision, it follows that limitations on the authority of the Government's contracting officers do not, in the absence of express statutory provisions, impose like limitations on the second party prime contractor in making subcontracts with third party subcontractors. There is no agency relationship between the prime contractor and the Government, and therefore there is no privity between the Government and the subcontractors.

The emergency acts refer only to the powers and limitations of the contracting officers of the Government and do not make any reference to methods of subcontracting. In the absence of a specific reference to subcontracts, what right have we to assume that these acts limit the rights of an independent contractor to exercise his discretion in subcontracting? In those instances where Congress intended provisions of the emergency acts to extend to subcontracts, specific provision was made therefor. Thus, Section 403 of the Sixth Supplemental National Defense Appropriation Act of 1942,¹⁰ in directing the renegotiation of excessive profits under war contracts,

⁹ *Curry v. United States*, 314 U. S. 14, 86 L. Ed. 9 (1941); *Alabama v. King and Boozer et al.*, 314 U. S. 1, 86 L. Ed. 3 (1941).

¹⁰ PUBLIC LAW 235, 78th Cong., enacted Feb. 25, 1944; PUBLIC LAW 528, 77th Cong., as amended by § 701(b) of the Revenue Act of 1943.

specifically provides that its terms are to apply not only to prime contracts but also to subcontracts.

In the *Day and Zimmerman* decision, the Comptroller General develops the opinion that CPPC subcontracts are inherently illegal, therefore it is of no consequence that the cost of the equipment furnished was audited and certified by the War Department as reasonable and just and no greater than would have been paid and reimbursed by the Government, had any other method been used. In support of this contention various cases involving usury, restraint of trade, etc., are quoted indicating that no court of justice can in its nature be made the handmaid of inequity, hence that there can be no legal remedy for that which is itself illegal.

A review of the history of cost-plus-a-percentage-of-cost system of contracting reveals that there has never been a blanket prohibition of its use, nor has it been declared illegal as such. Congress has merely provided that the CPPC system of contracting shall not be used in the exercise of the additional contracting powers granted to Government officials under the various emergency acts. No mention is made of subcontracts. Government contracting officers entering into contracts under acts other than those specifically denying the right to use the CPPC system of contracting, have the right to continue its use, even at the present time.

The theory that the CPPC system of contracting is inherently illegal appears to be contradicted in a subsequent decision of the Comptroller General, B-38322.¹¹ This case involved a prime contract entered into by the War Department, under authority of the Act of July 2, 1940, with the Blumenthal-Kahn Electric Co., providing for reimbursement on a cost-plus-a-percentage-of-cost basis subject to a maximum price of \$6,000. The final charge to the Government was \$4,403.76, of which amount \$4,046.49 represented the cost to the contractor and \$357.27 represented profit. The Comptroller General held that "The evident purpose of the Congress in prohibiting contracts on a cost-plus-a-percentage-of-cost basis is to avoid the evils which might flow from a situation whereby a contractor could purposely cause tremendous increase in the cost of work in order to increase its profits proportionately. Such a situation obviously could not arise in connection with performance of the instant contract in view of the stipulated 'ceiling' or maximum price and the definite and effective controls over the labor and materials to be utilized in the performance of the contract."

It is interesting to note that in the *Day and Zimmerman* decision, no weight whatsoever was given to the statements made by the War Department that adequate controls had been exercised in ascertaining that the cost of the subcontract therein involved was reasonable and in the best interests of the Government. The only difference in the two cases was the existence of a ceiling price in the *Blumenthal-Kahn*

¹¹ 23 COMP. GEN. 410 (1943).

case. What then is the significance of this factor? A "ceiling" price in a CPPC contract serves only as a means of assuring that the final cost will not be unreasonable. The cost of a contract could be reasonable, however (and was agreed to be reasonable in the *Day and Zimmerman*, decision), whether it has a maximum price or not. Conversely, of course, the cost of a contract could be unreasonable even if there were a "ceiling" price if the "ceiling" had been set too high.

The writer questions the theory that the presence of a maximum price converts a CPPC prime contract, which otherwise would be in contravention of the statute, into an acceptable form. In *United States v. 94.68 Acres of Land, St. Chas. Co., Mo.*,¹² the court rejected the reasoning advanced in support of a CPPC contract, stating, in part, as follows:

Congress, no doubt anticipating that learned, technical and weird definitions of cost-plus-a-percentage-of-cost contracts would follow a prohibition of a particular species of such contracts, wisely broadened the prohibition to extend to all transactions in which the system was used. What was the "system" and what was the vice to be eliminated? The system was the method of contracting whereby the Government agent's profit or compensation was increased in direct proportion to the cost of the object or commodity itself to the Government. The vice was the temptation, oftentimes not resisted, to deliberately or carelessly cause or permit the cost of the object to be increased in order to increase the profit.

In the *Blumenthal-Kahn* case, the presence of a maximum price does not cancel the fact that the contract was on a CPPC basis and the final reimbursement to the contractor was in the form of cost, plus a profit based on a percentage of such cost. Clearly, aside from the question of reasonableness, this constituted a CPPC system of contracting. The only effect of a "ceiling" price is to restrict the maximum beyond which the "evils" of a CPPC system of contracting cannot exceed; it does not do away with such "evils" prior to the point at which the maximum price is reached. Assuming, however, for the sake of argument that the presence of a "ceiling" price and other controls insured the reasonableness of the final cost of the contract and therefore made it valid, this theory if applied to *Day and Zimmerman's* subcontract would result in its being considered valid, because the cost of the subcontract had been audited and certified by the War Department as being in the best interests of the Government.

The decision in the *Day and Zimmerman* case rests strongly on the assumption that if subcontracts are not covered, the prohibition against the CPPC form of contracting could be substantially evaded and the purposes thereof defeated. This argument is faulty because it does not take into consideration the fact that all CPFF prime contracts provide that the Government will only reimburse the contrac-

¹² 45 F. Supp. 1016 (D. C. 1942).

tor for reasonable costs incurred in the performance of the contract. There is, therefore, ample authority on the part of the Government to disallow unreasonable costs or profits earned under CPPC subcontracts without resorting to the necessity of reading into the law a provision with respect to subcontracts which does not appear therein. By disallowing the portion of a CPPC subcontract considered unreasonable, the original purpose of Congress will have been fulfilled. The disallowance of the entire amount of subcontracts solely because they are on a CPPC basis, without any consideration of the value of the goods and services rendered the Government, would be taking advantage of a technicality in direct violation of the trust relationship inherent in every CPFF prime contract.

Congress has repeatedly recognized that the present emergency involving our national defense, calls for a high degree of cooperative confidence and trust by each contracting party in the other to insure the successful accomplishment of vital war contracts. This policy is expressed in the Contract Settlement Act of 1944,¹³ wherein it is provided that "Whenever any formal or technical defects or omission in any prime contract, or in any grant of authority to an officer or agent of a contracting agency who ordered any materials, services, and facilities might invalidate the contract or commitment, the contracting agency (1) shall not take advantage of such defect or omission; (2) shall amend, confirm, or ratify such contract or commitment without consideration in order to cure such defect or omission; and (3) shall make a fair settlement of any obligation thereby created or incurred by such agency, whether expressed or implied, in fact or in law, or in the nature of an implied or quasi contract."

If the Comptroller General's decision in the *Day and Zimmerman* case were applied to the numerous subcontracts entered into on a CPPC basis, the Government would be prohibited from reimbursing contractors for any portion of the cost of such subcontracts regardless of the fact that the prices were reasonable and that the goods had been received and used by the Government. Unless the decision in the *Day and Zimmerman* case is reversed, war contractors will sustain a loss of millions of dollars, in direct violation of the expressed intent of Congress to conduct war contracting on a fair and equitable basis.

RAPHAEL J. MUSICUS.

THE DOCTRINE OF "THE LAST CLEAR CHANCE"

As an outgrowth of society's high regard for persons and property, the doctrine of "the last clear chance" was formulated in England and later adopted by the courts of the United States. In effect, the rule prescribes a course of conduct demanded by society when situations arise wherein one of its members, through negligence or

¹³ PUBLIC LAW 395, 78th Cong., c. 358, 2d Sess.