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COMPENSATION FOR TERMINATED FIXED-PRICE SUPPLY WAR CONTRACTS

Edward S. Feldman*

I

INTRODUCTION

THE enormous volume of government contract cancellations requires a fuller understanding by contractors of the principles of securing fair compensation promptly for their charges if they are to have funds to reconvert their plants and operate them successfully. As the Director of Contract Settlement stated in a recent report to Congress, "The contracting agencies alone cannot do the contract settlement job. Contractors, too, must be willing and able to do their part. To be adequately prepared, contractors must be able (1) to make out claims and (2) to process claims of their subcontractors and suppliers."1

Although many of the problems and procedures connected with terminations are of an accounting nature, legal advice will frequently be needed in borderline situations, in negotiations, and—if it must be—in litigation. Ordinarily, there will be little need for actual litigation, for the tools with which to prepare cancellation charges have been made available in advance, have been carefully thought out, and are being administered liberally. It is the purpose of this article to explain the methods of obtaining fair compensation for charges which have been incurred by war contractors, whether they are prime or subcontractors. Lawyers must be familiar with these techniques before any approach to a contractor's specific difficulties can be made. However, no attempt is made here to cover property disposition, compensation for cost-plus-a-fixed-fee contracts, interim financing, legal review of set-

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1 Third Report by the Director of Contract Settlement, April 1945, C.C.H. War Law Serv., 2 Govt. Contracts, 31,084.
tlements, or various other collateral matters vital to the settlement of war contracts, but which are outside the scope of this paper.  

A. Pre-World War II Experience

We need not here go into the experience of settling terminated war contracts arising out of World War I. Articles on this subject have already appeared. Generally, it may be said that the principal difficulties in settling those terminations related to the amount of profit allowable. Only recently has the extended litigation been finally settled. But this experience has been carefully utilized in the formulation of the Contract Settlement Act of 1944, which Senator Murray, a principal author of the act, characterized as one of the most thoroughly considered laws in the history of the Congress.

B. The Tools for Terminations

The source materials for information and regulations will be briefly described for convenience. These are the materials used by an entirely new administrative body in conjunction with the operations of procurement agencies already in existence, and since they deal with a comparatively new subject are not widely known as yet.

1. The Contract Settlement Act of 1944. This act became effec-
tive on July 21, 1944, after many months of hearings and study. It forms the comprehensive framework within which most war contracts will be settled. 7

2. Regulations of the Office of Contract Settlement. Section 4(a) of the Contract Settlement Act provides for the establishment of the Office of Contract Settlement to be headed by a director who is to prescribe policies, principles, methods, procedures and standards to govern the exercise of the authority and discretion and the performance of the duties and functions of all government agencies under the act. 8

3. Surplus Property Act of 1944. 9 This act was designed to establish statutory procedures for the handling of surplus war property which had been disposed of by the Surplus War Property Administration, acting under Executive Order No. 9425. 10

4. War Mobilization and Reconversion Act of 1944. 11 By virtue of this legislation the former Office of War Mobilization created by Executive Order No. 9347 12 is superseded by the Office of War Mobilization and Reconversion. The Office of Contract Settlement which was created by the Contract Settlement Act, and the Surplus Property Board which was created by the Surplus Property Act were placed within the Office of War Mobilization and Reconversion and they exercise their duties under supervision of the director of that office.

5. Joint Termination Regulation. The War and Navy Departments have jointly adopted this regulation to establish uniform policies and procedures for administering the termination of war contracts, terminations settlements, interim financing and related matters. 13 In

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7 Under § 25 of the Contract Settlement Act, 41 U.S.C. (1940), Supp. IV, § 125 the contracting agencies, subject to policies of the Director of Contract Settlement, may exempt their foreign contracts from the act. The War and Navy Departments and the Foreign Economic Administration have already done so. See the Third Report of the Director of Contract Settlement.

8 Contract Settlement Act, § 4 (b) (1), 41 U.S.C. (1940), Supp. IV, § 104 (b) (1).


10 9 FED. REG. 2071 (Feb. 19, 1944).


12 May 27, 1943, 8 FED. REG. 7207 (June 1, 1943).

13 Joint Termination Regulation, 111.1, C.C.H. WAR LAW SERV., 1 Govt. Con-
its original form, it was issued on November 1, 1944, when it became binding upon the War Department. However, it did not become binding upon the Navy Department until December 1, 1944. Several revisions have been issued since the first publication.

6. *Joint Termination Accounting Manual.* The Accounting Manual is part of JTR and supersedes, in the case of the War Department, its TM 14-1005, *Termination Accounting Manual for Fixed-Price Supply Contracts.* It provides procedures for the information and guidance of accounting personnel of the War and Navy Departments in accomplishing the objective of service to the contracting officer. The manual is also offered to termination personnel of contractors for their information and assistance.

7. *Regulations of the Reconstruction Finance Corporation.* Pursuant to the Contract Settlement Act, the Reconstruction Finance Corporation has issued part 50 of its Regulations, entitled “War Contract Terminations, Claims, Settlements, and Interim Financing.” This was issued for the guidance of the Reconstruction Finance Corporation, the Defense Plant Corporation, the Defense Supplies Corporation, the Metals Reserve Company and the Rubber Reserve Company.

8. *Regulations of the Maritime Commission.* On August 10, 1944, the United States Maritime Commission issued its regulations pursuant to section 4(c) of the Contract Settlement Act. These regulations,
which were revised March 6, 1945, provide no basic variation from the principles in the Joint Termination Regulation.

9. Regulations of the Department of Agriculture. Following the mandate of the Contract Settlement Act, the Department of Agriculture also issued regulations with respect to the settlement of claims arising under terminated war contracts (June 8, 1945).

C. Some Definitions

An understanding of the nomenclature used is essential to comprehension of the principles of compensation. Certain definitions are given here, and others appear in the text of the Contract Settlement Act. 16

A war contractor is anyone who holds a war contract. 17 Such war contract may be a prime contract or a subcontract. A prime contract is any contract, agreement or purchase order entered into by a contracting agency and connected with or related to the prosecution of the war, 18 while a subcontract is any contract, agreement, or purchase order entered into to perform work or to make or furnish any material to the extent that such work or material is required for the performance of any one or more prime contracts or any one or more other subcontracts. 19

"The terms 'termination,' 'terminate,' and 'terminated' refer to the termination or cancellation, in whole or in part, of work under a prime contract for the convenience or at the option of the Government (except for default of the prime contractor) or of work under a subcontract for any reason except the default of the subcontractor." 20 A "termination claim" is usually any claim or demand by a war contractor for fair

16 Section 3 (c) of the Contract Settlement Act, 41 U.S.C. (1940), Supp. IV, § 103 (c), contains most of the basic definitions.
17 Contract Settlement Act, § 3 (c), id. U.S.C., § 103.

"If termination of work under this contract is simultaneous with, a part of, or in connection with, a general termination (1) of all or substantially all of a group or class of contracts made by the War (Navy) Department for the same product or for closely related products, or (2) of war contracts at, about the time of, or following, the cessation of the present hostilities, or any major part thereof, such termination shall only be made in accordance with the provisions of this Article, unless the contracting officer finds that the contractor is then in gross or wilful default under this contract."

compensation for the termination of any war contract. Ordinarily the termination claim includes a charge for a “termination inventory” which means those materials (including a proper part of any common materials) which are properly allocable to the terminated portion of the contract. Any machinery or equipment, however, which is subject to a separate contract specifically governing the use or disposition thereof is not to be included in the termination inventory.21

D. The Framework

Section 6 (a) of the Contract Settlement Act declares that

“It is the policy of the Government, and it shall be the responsibility of the contracting agencies and the Director, to provide war contractors with speedy and fair compensation for the termination of any war contract, in accordance with and subject to the provisions of this chapter, giving priority to contractors whose facilities are privately owned or privately operated. Such fair compensation for the termination of subcontracts shall be based on the same principles as compensation for the termination of prime contracts.”

Section 6 (c) states that

“Any contracting agency may settle all or any part of any termination claim under any war contract by agreement with the war contractor, or by determination of the amount due on the claim or part thereof without such agreement, or by any combination of these methods.”

Section 6 (b) states that

“...To the extent that such methods and standards [for determining fair compensation] require accounting, they shall be adapted, so far as practicable, to the accounting systems used by war contractors, if consistent with recognized commercial accounting practice.”

The declarations found in these quotations form the framework for the settlement of claims arising out of terminated war contracts. Basically, the act recognizes the previously established methods of settling these contracts, namely by negotiation and by formula, and adds recourse to arbitration.22 Instead of the words “negotiation” and “formula” which are commonly used, the act uses the words “agreement” and “determination.”

II

The Methods of Settlement

After a war contract has been partially or totally cancelled, the contractor will take certain steps to ascertain the charges which he has incurred because of the reduction of the order by the contracting agency. Upon receipt of a termination notice the contractor must do the following things when appropriate:

1. Suspend all work as promptly as is practicable. However, when it appears that special circumstances make it necessary or desirable to continue production in order effectively to utilize material or work in process (as, for example, in the case of nearly finished contract items) the contractor may inform the contracting agency of these conditions and obtain permission to continue the work. The Contract Settlement Act provides that the contracting agency shall permit continuation whenever it deems that such continuation will benefit the government or is necessary to avoid substantial injury to plant or property. Otherwise, no further work must be done unless for the contractor's own account at his own expense, as work done after a reasonable period has elapsed following receipt of the termination notice will not be the basis for any compensation or reimbursement of costs in connection with the termination settlement.

2. Suspend the placing of all orders and subcontracts pertaining to the terminated portion of the contract.

3. Terminate as promptly as possible all subcontracts and cancel all orders placed pertaining to the terminated portion of the contract.

4. Take steps to protect property in which the government has, or may acquire, an interest.

5. Notify the contracting officer of any pending or subsequent legal proceedings against the contractor based upon any subcontracts or commitments related to the terminated prime contract.

6. Proceed to prepare an inventory of property allocable to the contract, a statement of costs and a proposal for settlement of amounts

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24 Contract Settlement Act, § II (a) (3), 41 U.S.C. (1940), Supp. IV, § 111 (a) (3); JTR 251.1 and 251.3 (1), C.C.H. War Law Serv., I Govt. Contracts, ¶¶ 10,251, 10,251.3. The production of completed articles in advance of schedules will not be considered unreasonable where such production (a) was requested or approved by the government, or (b) was required for economic or efficient performance of the contract and was done in good faith. JTR 252.1 (3), id., C.C.H., ¶ 10,252.1 (3).
due by reason of the termination. Similar statements and proposals should be obtained from subcontractors.

Each subcontractor should, in turn, follow substantially these same procedures with his subcontractors if there are any. Much of this work can be, and has been, done in advance of actual termination by arriving at predetermined settlements. The ideal predetermination arrangement is a formal binding agreement. Such agreements can be reached in many industries whose production methods are such that a basis of fair compensation for termination can be arrived at beforehand. Prices are agreed upon at which the manufacturer will take over or sell all the different elements of the work in process in the various stages of processing. The methods of arriving at administrative and other overhead expenses are agreed upon in advance. Upon termination all that is necessary is to take a physical inventory. This inventory, together with the previously agreed prices, determines the amount of the settlement. Predetermination planning may be carried out down the contractual chain, through prime contractors to subcontractors. See Office of Contract Settlement Regulation (cited as Regulation) No. 3, 9 FED. REG. 1184 (Sept. 28, 1944); Regulation No. 6, 9 FED. REG. 12283 (Oct. 10, 1944); and Regulation No. 9 of the Surplus Property Board, 10 FED. REG. 7413 (June 20, 1945). See also JTR 224-227, C.C.H. WAR LAW SERV., 1 Govt. Contracts, §§ 10,224-10,227.

Settlement of contracts between the government and the prime contractor, between the prime contractor and his subcontractors and so on down the line is referred to as the “vertical” method of settlement or “procurement in reverse.” Regulation 16, 10 FED. REG. 6249 (May 29, 1945), now provides, in accordance with the Contract Settlement Act, for “company-wide” or “horizontal” settlement, wherein direct settlement is made by a contracting agency on a company-wide basis of termination claims of certain war contractors under war contracts with one or more bureaus or divisions within a contracting agency, contracting agencies, or prime contractors and subcontractors. Considerable experimentation on the part of the services preceded the adoption of this regulation. See JTR 820 et seq., C.C.H. WAR LAW SERV., 1 Govt. Contracts, §§ 10,820. See also Col. R. H. Andrews and Lt. C. Hill, “Direct Settlement of Terminated War Contracts on a Company-wide Basis,” 80 JOUR. OF ACCOUNTANCY 96 (1945).

Review and Approval of Claims. Under § 7 (a) of the act, contracting agencies are directed to authorize war contractors to make settlements with subcontractors without review by the contracting agency whenever the reliability of the war contractor, the amount or nature of the claims, or other reasons, appear to the agency to justify such action. Under such authorization, the war contractor may settle finally any subcontract claim involving not more than $10,000 (after deducting amounts payable for work completed at the contract price and settlements with lower tier contractors previously authorized, but without deducting other subcontractors’ claims or disposal credits); where all the subcontractor’s termination inventory is retained by him, sold at the best price obtainable with value or proceeds being credited to the government, or transferred to it; and where the settlement bears a certificate stating that the claim is allocable to the upper tier contract and is fair and reasonable in amount (form at JTR 987.1, C.C.H. WAR LAW SERV., 1 Govt. Contracts, §§ 987.1). JTR 642.3, id., C.C.H. §§ 10,642.3. Where a war contractor settles in good faith with a subcontractor in accordance with such authorization, the government and higher tier contractors will recognize the settlement, including credits for retention or disposal of termination inventory, as final and conclusive for the purpose of settling the prime contract to which the subcontract is allocable.

Where a war contractor in good faith approves a settlement proposal properly
A. Settlement by Negotiation (Agreement)

As we have seen, the Contract Settlement Act provides for several methods of awarding fair compensation for terminated war contracts. But if contracts are to be settled promptly and funds made available to business for reconversion, and if plants are to be cleared quickly of termination inventory and new production started, most of such contracts will have to be settled by agreement between the contracting agencies and the contractors. That is to say that a given contractor will assemble his charges in a manner to be described below and will present a settlement proposal to his contracting officer. He, in turn, will review the proposal and will accept it as is, reject it, or seek to have it modified in various respects—possibly after an audit of the contractor's books of account and an examination of his accounting system. Some items will be allowed, others may be adjusted, or disallowed, depending upon the judgment of the contracting officer governed by existing law and regulations. The negotiated settlement is the most expeditious and most satisfactory method of settling termination claims and his method will be used for settlement whenever feasible. Ordinarily, other methods will be resorted to only when a termination claim cannot be fairly settled by agreement. Not only is the negotiated settlement provided for by statute, but it is also provided for by the uniform termination clause.²⁷

submitted to him on form 12, id., C.C.H. ¶ 10,961 (settlement under $1,000, with contractor retaining inventory) by his immediate subcontractor, the government will recognize the settlement, including credits for retention or disposal of inventory, as final and conclusive for the purpose of settling the terminated prime contract or adjusting the continuing prime contract (whether modified or not) to which the subcontract is allocable, unless the authority so to settle has been revoked. In other words, no further authorization is needed to make such approvals. JTR 643.1, id., C.C.H. ¶ 10,643.

Any settlement between a war contractor and his subcontractor which is authorized, approved or ratified by the contracting agency is final and conclusive as to the amount due except (1) to the extent otherwise agreed in the settlement; (2) for fraud; (3) upon renegotiation under the Renegotiation Act; or (4) by mutual agreement before or after payment. Contract Settlement Act, § 7 (a), 41 U.S.C. (1940), Supp. IV, § 107 (a). The act provides that no war contractor shall be liable to the United States on account of any amounts paid on such settlements, except for his own fraud.

Every proposal for settlement of a terminated contract must receive an office review by the war contractor, and every claim, the net amount of which, after deducting all disposal credits, exceeds $1,000, must receive an accounting review. JTR 633, id., C.C.H. ¶ 10,633. A memorandum of each office review must be made and must be available to government personnel. THE JOINT TERMINATION ACCOUNTING MANUAL sets out procedures for review, id., C.C.H. ¶ 12,001.

²⁷JTR 931, id., C.C.H. ¶ 8001. Negotiated settlement is also implied in the
I. Types of Settlement Proposals

Before a contracting agency or a war contractor can proceed to settle a terminated contract, the contractor and the agency must have adequate information available supporting the claim or proposal as a basis for negotiations; there must be enough data presented to permit a "sound business negotiation for a fair settlement." No matter how the claim is presented, though, its purpose is not to afford an exact and precise determination of costs, nor the strict application of any formula, "but rather to provide adequate data for the exercise of sound and informed business judgment in reaching a settlement.... The information in the war contractor's proposal for settlement should support the amount he requests to compensate him fairly for the termination of the contract, without recognizing any profit on work not done. Ordinarily, this amount should cover the work done and preparations and commitments made for the terminated portion, plus a reasonable profit on the work done, and post-termination expenses, less any credits for the proceeds or value of any termination inventory retained or disposed of by the war contractor, but it should not include any amount for completed articles invoiced at the contract price...."

As might be expected, there are various ways of preparing a claim to be used as the basis for negotiating a settlement. These are provided for under the Contract Settlement Act. Standardized forms also have been devised which are predicated upon these different methods.

a. Inventory Basis

Under the inventory basis, the costs allocable to the work done on uniform subcontract clause, JTR 936, id., C.C.H. ¶ 8061, and is also provided for in most termination articles in use prior to the present uniform articles.

28 JTR 521, id., C.C.H. ¶ 10,521. Finished articles in hands of the prime contractor will be inspected by the government and if acceptable will be transferred to the government at the contract price. If this is done, the finished items will be excluded from the termination claim. JTR 252.1, id., C.C.H. ¶ 10,252.1. When the articles are not delivered and invoiced under the contract, they may be included in the claim, if the contract price is appropriately adjusted for any saving of freight or other charges, together with any credits for their retention or disposition. JTR 252.2 (1), id., C.C.H. ¶ 10,252.2.

29 "Each contracting agency shall establish methods and standards, suitable to the conditions of various war contractors, for determining fair compensation for the termination of war contracts on the basis of actual, standard, average, or estimated costs, or of a percentage of the contract price based on the estimated percentage of completion of work under the terminated contract, or any other equitable basis, as it deems appropriate. To the extent that such methods and standards require accounting, they shall be adapted, so far as practicable, to the accounting systems used by war contractors, if consistent with recognized commercial accounting practice." § 6 (b), 41 U.S.C. (1940), Supp. IV, § 106 (b).

30 JTR 522, C.C.H. WAR LAW SERV., 1 Govt. Contracts, ¶ 10,522. See JTR
the uncompleted portion of the war contract, plus profit, if any, plus the costs of settling with subcontractors and any other applicable costs are presented in the claim.\footnote{JTR 523.2, id., C.C.H. \S 10,523.2.}

When this method is used, the inventories on hand of purchased parts and work in process must be priced in detail. This is the primary problem, and requires an adequate cost accounting system in order to secure this information. The work in process inventory will be broken down into material, labor and overhead costs for each item listed at its particular state of completion. Tools, dies, jigs and fixtures will also be listed. Of this latter inventory, however, the entire cost of the items may not be included—but rather only that part which remains to be “amortized” over the uncompleted portion of the contract. If, for example, jigs and fixtures cost $500 to make, and the contract was cancelled when it was 75 per cent complete, only $125 can be added in the termination claim.\footnote{For rules relating to special tools, see JTR \S IV, pt. 7, id., C.C.H. \S 10,470 et seq. See also the discussion of accounting for engineering and development, special tooling and preparatory expenses in Termination Cost Memorandum No. 10, infra, note 71.}

To the above inventories are added those items of expense which have not already been included: general and administrative expenses have already been included: general and administrative expenses

\footnote{JTR 523.2, id., C.C.H. \S 10,523.2.}

\footnote{For rules relating to special tools, see JTR \S IV, pt. 7, id., C.C.H. \S 10,470 et seq. See also the discussion of accounting for engineering and development, special tooling and preparatory expenses in Termination Cost Memorandum No. 10, infra, note 71.}
allocable to the value of the inventories, initial engineering costs and test equipment. Profit, if any, is taken on the sum of these items, which should be set out in detailed schedules with actual computations being shown.

The inventory method is preferred when it can be equitably used.\textsuperscript{88} Where there is a good cost system this method should work well, since no trouble will be experienced in computing unit costs. If the contract has run almost to completion this method should be used because it gives the most accurate picture of costs. Where very little work has been done, and there are inventories of raw materials and purchased parts on hand, the inventory basis is also useful.

If, instead of a profit, it is apparent that a loss is being suffered on the contract, no change need be made in procedure under the inventory basis, because only costs—not billing or payments—enter into the computation of the claim.

b. Total Cost Basis

If no dependable unit cost information is available, or if a contract is cancelled in its early stages and heavy developmental and engineering expenses have been incurred initially, resort may be had to the total cost method.\textsuperscript{84} Total costs must be collected because unit costs do not include all allocable costs.

In setting up a cost system it is implicitly assumed that no cancellations will take place before completion of the work scheduled. The total cost method recognizes that all legitimate costs may not therefore be included at cancellation and offers a simple solution when terminations occur early and after large initial costs.

Inventories of raw materials, purchased parts and supplies must be itemized. While they do not have to be priced in detail to satisfy the requirements of the total cost method, as such, in practice, detailed pricing will be required to provide a means for disposal of the property. To the extent possible the work in process inventory should also be priced.

All other costs which have been accumulated to the time of termination are added in. A profit allowance is added to this. From the total of these amounts is deducted what the government or prime contractor has paid or will pay on account of completed items. The difference is the amount of the claim.

\textsuperscript{88} JTR 525.2 (1), C.C.H. War Law Serv., 1 Govt. Contracts, § 10,525.2. For a discussion of the results obtained under the various bases, see Government Contract Terminations, Ill. Manu. Assoc. Pub., 27 (1945).

\textsuperscript{84} JTR 523.3 (1), C.C.H. War Law Serv., 1 Govt. Contracts, § 10,523.3.
When a loss is indicated the procedure will have to be altered somewhat. Whereas the contract price of completed items is deducted when a profit is shown, when a loss is revealed, it is clear that the contract price is something less than the actual cost. The contract price must therefore be adjusted upward to represent the actual cost, and it is this amount which is deducted from the sum of costs incurred on the contract to the time of termination. An example will help clarify this: Assume that there has been an indicated loss of 6 per cent on an entire contract and payments received and to be received of $650,000:

Then payments received and to be received for the completed portion of the contract must represent 94 per cent of the cost.

\[
\text{Indicated cost of completed portion:} \quad \frac{650,000}{.94} = 691,489.
\]

\[
\text{Total contract costs incurred to date of termination} = 1,000,000.
\]

\[
\text{Deduct indicated cost of completed portion} = 691,489.
\]

\[
\text{Indicated equitable settlement for uncompleted portion before deduction for disposal credits and excluding subcontractors' charges} = 308,511.
\]

\[
\text{Total payments to the contractor plus the indicated amount would then be:}
\]

\[
\text{Payments received and to be received for completed portion} = 650,000.
\]

\[
\text{Indicated equitable settlement for uncompleted portion before deductions for disposal credits and excluding subcontractors' charges} = 308,511.
\]

\[
\text{Total payments to the contractor} = 958,511.
\]

The loss is not 6 per cent of the costs to date of termination, but is 6 per cent of the completed portion of the contract.

\[\text{JTR 523.3 (2), id., C.C.H.} \parallel 10,523.3. \text{This procedure is not to be applied in the case of contracts which contain an article permitting upward price adjustment and having retrospective effect, if the contract is terminated before the occurrence of the event giving rise to renegotiation or determination of such price adjustment. JTR 535.1 (3), id., C.C.H.} \parallel 10,535.1.\]
c. Percentage of Completion Basis

In submitting a proposal which amounts to less than $1000 after deducting disposal credits for the entire inventory, the war contractor may base his proposal on a percentage of completion of work under the war contract, where that method will provide fair compensation upon termination.86

In addition, the contracting officer may authorize this basis of settlement in any other case.

d. Other Bases

In submitting a proposal which amounts to less than $1000 after deducting disposal credits for the entire inventory, the war contractor may calculate his proposal by any alternative method which will provide fair compensation for termination.87 Special authorization must be secured to use another basis in the case of proposals above $1000.

2. The Elements of Cost and Profit

In negotiating the amount to be paid the contractor as fair compensation for his claim, it is not necessary that the contracting officer and the contractor agree on the separate items to be allowed either for costs or profit. The primary objective in negotiating a settlement is to agree on an amount to compensate the war contractor fairly and fully for the work done and the preparations made for the terminated portion of the contract, with such allowance for profit thereon as is reasonable under the circumstances. "Such fair compensation for termination is inherently a matter of judgment and therefore cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation; and differing amounts, resulting from reasonable variations of method and of sound judgment, may all be regarded as constituting fair compensation. Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it...."88 For the purpose of expediting settlements, costs may be estimated and approximated on reasonable bases, to the fullest extent practicable. Differences will be compromised and questions of doubt settled by agreement.89

87 JTR 523.5 (1), id., C.C.H. ¶ 10,523.5.
88 JTR 531, id., C.C.H. ¶ 10,531.
89 JTR 532.2 (2), id., C.C.H. ¶ 10,532.2.
We shall see that when negotiations fail and no settlement by agreement can be reached between the contractor and the contracting agency, settlement must be reached unilaterally by formula by the contracting officer. In this case items which will be allowed as costs are governed by the "Statement of Principles for Determination of Costs upon Termination of Government Fixed-Price Supply Contracts." Strictly speaking, the Statement of Principles applied only to formula settlements under the standard or uniform contract termination clause. However, Regulation No. 7 declares that the "Statement of Cost Principles reflects certain policy determinations regarding the type of costs which should be taken into account in determining the compensation to which the contractor is fairly entitled by reason of the termination of his contract for the best interest of the government. Contractors can properly expect that their costs of the types described by the Statement of Cost Principles as includible will be so taken into account in a settlement by agreement. Conversely, such a settlement should not be made the means for reimbursing expenditures of the types which the Statement excludes." Consequently, even though a formula determination may be only infrequently utilized, principles of such determinations will be used where the negotiation of the total amount is based upon the consideration of costs and profits. It becomes necessary, obviously, to be familiar with the Statement of Cost Principles and its interpretations. These are discussed under formula settlements.

"Fair compensation" presumably includes an allowance for profit on the uncompleted portion of the contract. Thus, "A reasonable allowance for profit" is specifically mentioned in the uniform termination article, although the Contract Settlement Act mentions profit only in the section on settlements by determination.

Regulation No. 7 is very broad in its approach to the determination of the amount of profit to be included in the settlement. "Profit should be limited to preparations made and work done for the terminated portion of the contract; but, subject to this limitation, any reasonable method of arriving at a fair profit may be used. The most satisfactory criterion of what is fair profit on the terminated part of a contract is ordinarily a proper portion of what the parties have agreed upon. Evidences of this agreement might be either (a) the amount of the profit which was agreed upon or contemplated by both parties at the time when the contract was negotiated; or (b) the amount of profit which the contractor would have earned had the contract been completed; or

41 Id. at ¶ 4 (c).
(c) the amount of profit which the contractor agreed to accept in the event the contract was terminated and litigation resulted. Ordinarily, the ascertainment of the profit which the contractor would have earned had the contract been completed would involve complicated time-consuming forecasts which cannot in practice be made with reasonable accuracy, and the most satisfactory substitute for this criterion will be the amount of profit which the parties agreed upon at the outset. Accordingly, the following considerations may be taken into account in arriving at a reasonable profit, whether determined separately or as part of a reasonable over-all total.

"Where satisfactory evidence is available and it is practicable to do so, one method of arriving at a reasonable profit on the terminated portion of the contract is as follows:

(i) Ascertain the dollar amount of the profit which was agreed upon or was contemplated by both parties at the time when the contract was negotiated.

(ii) Allow the contractor the portion of the amount determined by the relation between the work performed by him on the terminated portion of the contract and the work contemplated by the entire contract.

(iii) The estimate of this relationship does not necessarily depend on the percentage of the costs incurred on the terminated portion of the contract to total estimated costs, nor on the percentage of materials acquired for this portion to total materials required. While these factors should be considered, emphasis should rather be put on the extent and difficulty of the work completed by the contractor (including engineering work, production scheduling, planning, technical study and supervision, arrangement and supervision of subcontracts, as well as other services) as compared with the total work required of him by the contract. Engineering estimates of percentage of completion should not ordinarily be required, although entitled to proper consideration if available.

"This principle will result in fair compensation in cases which have involved the arrangement of subcontracts and the supervision of their performance, by reflecting this work in the estimate of the extent of completion, while at the same time properly avoiding the practice of measuring the prime contractor's profit by the amount of his payments to subcontractors for their termination claims. This principle will also avoid excessive compensation in cases where a large proportion of the contractor's costs represents merely the acquisition of materials not processed by him.
"Another method which may be appropriate is to approximate the amount of the profit which the contractor would have been entitled to receive under the formula in his contract in the event of the failure of the parties to agree. This will be especially helpful in cases or classes of cases where it is impossible to determine the amount of profit in accordance with the principles stated...[above], or where payment of this approximation of the formula will increase speed of settlement, or where it appears that the contractor would have failed to realize a profit in the event of completion of the contract." 42

The Joint Termination Regulation does not tie the contracting officer down to any particular method of computing what the profit allowance will be in negotiating a settlement. In no case, however, will the contractor be allowed profit on any work which is not done—but only on work which is actually performed and materials actually obtained or furnished. 48 This, of course, is in contradistinction to the common law rule of damages which allows the contractor the profits he would have received if the contract had run to completion. The profit percentage, or percentages, whatever it or they may be, will be taken on the total of the contractor's costs (excluding settlements with contractors, post termination expenses and like costs). The profit allowed after renegotiation may exercise a strong influence in determining the rate of profit allowed in settlement of the termination claim, as well as the limits usually set in the uniform termination article, namely 2 per cent on unprocessed materials, 8 per cent on other costs, not to exceed 6 per cent overall. 44

The gross amount of the settlement, excluding sums paid to compensate for post termination expenses and services, may not exceed the contract price, minus payments otherwise made or to be made under the contract.

3. Price Adjustment Articles

Many War Department fixed-price supply contracts contain articles providing that upon the occurrence of specified events the contract prices of the items thereafter to be delivered will be readjusted either by negotiation or by formula. Other price adjustment articles provide

42 JTR 931 (c), id., C.C.H. § 8001; JTR 533 (2), id., § 10,533.


44 Where the contractor desires to approximate the formula in a negotiated settlement, it will be appropriate for the government to agree. JTR 534.1, id., C.C.H. § 10,534.1.
that upon the occurrence of specified events the contract price of the items theretofore delivered as well as thereafter to be delivered will be adjusted either by negotiation or by formula. Where the contract is terminated after the occurrence of an event giving rise to a right to a negotiation or computation looking to a price adjustment but before its completion, the adjustment negotiations or computations will normally be carried promptly to conclusion by the parties. Price adjustments and negotiations or computations relating thereto will, wherever practicable, be concluded prior to, and will be reflected in, the final settlement agreement. 46

Some price adjustment articles specifically recognize the possibility of termination, and set out the effect to be given to these articles in the event of a formula settlement under the uniform termination article. In the case of a contract containing such an article, consideration will be given, in negotiating a settlement, to the rights of either party to a price adjustment. The negotiated settlement, however, is not to be used to effect an adjustment in the price of items delivered in any period as to which there would have been no adjustment if the contract had continued to completion. 46

In certain price adjustment articles providing for retrospective as well as prospective price adjustment there is no provision with respect to the relation between price adjustment and termination. If a contract containing such an article is terminated before the event giving rise to a right to a computation or negotiation looking to a price adjustment has occurred, neither party has any right to an adjustment of the contract price of articles delivered prior to termination. However, in this event the limitation on such costs as experimental and research expense, engineering and development and special tooling expense, loss on facilities, special leases and advertising expense shall apply only to the extent that such limitation would have applied if the contract had been completed and adjustment of the price had been negotiated or determined. Due allowance may be made for high initial cost of production, and where the indicated profit rate is to be given weight, the fact that the contract contains a price adjustment article is to be considered.

46 JTR 535.1, id., C.C.H. ¶ 10,535.1. For the effect of the Navy Department's price adjustment articles, see JTR 535.2, id., C.C.H. ¶ 10,535.2.
47 JTR 535.1 (3), ibid.
4. Partial Negotiated Settlements

Partial settlements which are final and not subject to being reopened except for fraud may be available in various kinds of situations: 48

(a) When the contractor approves subcontractors' proposals for settlement which are in turn approved by the contracting officer, or when property has been disposed of and credits arise from such disposition.

(b) When the contracting officer has only been able to negotiate a settlement as to part of the matters involved in the termination. In this case a partial settlement agreement may be made as to the separable issues. Remaining issues will be settled by determination.

(c) Partial settlements may be made to cover payments for completed articles which are a part of the termination claim.

(d) Whenever he considers it appropriate, the contracting officer may agree with the prime contractor on a partial settlement fixing an amount which the government agrees to be the minimum amount due on the entire claim without determining that this amount is due on particular elements of the claim or that additional amounts may not be due. This will assure the contractor that he will not be required to refund any part of this minimum amount, but otherwise leaves the final amount due on the entire claim to be negotiated.

5. The Settlement Agreement

When the contractor and the contracting officer reach an agreement on the amount of the settlement, a supplemental agreement for final termination of the contract will be entered into by them. 49 In the case of final settlement agreements for use after complete termination, all claims, rights and obligations of either party (other than those expressly excepted and reserved) arising under the terminated war contract will be discharged and released by the agreement.

The supplemental agreement will take into account the following deductions and reservations: whether and to what extent the terminated contract and the settlement agreement are to be excepted from subsequent renegotiation; deductions for damaged property and defects; deductions for government counterclaims or offsets in connection with the contract; disposal credits; provision for protection of

48 JTR 515, id., C.C.H. ¶ 10,515.
49 JTR § VII, pt. 4, id., C.C.H. ¶ 10,740 et seq.
subcontractors; rights reserved to the government or to the contractor; and offsets and credits for payments previously made to the war contractor by the government.

B. Settlement by Formula (Determination)

Where negotiations fail to result in an agreement as to the amount for which the war contractor is to be reimbursed, resort must be had to the so-called "formula" settlement (or, as it has been termed in the Contract Settlement Act, settlement by "determination"). The formula is simply a statement contained in the uniform contract termination article which lists the items of cost and profit for which the government must pay upon termination. These items are set out in some detail below.

The formula presently in use is substantially the same in both prime contract and subcontract forms. But whereas the uniform termination article is to be found in most prime contracts, or may be inserted therein at the wish of the prime contractor, no such regularity exists in the case of subcontracts. In the latter instances termination provisions vary all the way from inclusion of the very latest approved uniform termination clause for subcontracts to absolutely no termination provisions at all.

"Where any war contract does not provide for or provides against ... fair compensation for its termination, the contracting agency, either before or after its termination, shall amend such war contract by agreement with the war contractor, or shall authorize, approve, or ratify an amendment of such war contract by the parties thereto, to provide for such fair compensation." The Office of Contract Settlement has ruled that the current termination articles which are used provide fair compensation. Therefore, in order to assure speedy settlement each

50 The article is set out in JTR 931, id., C.C.H. ¶ 8001. For the formula, see paragraph (d).

Where any war contract contains a formula for determining the amount due if terminated different from that prescribed in the uniform article, the provisions of the formula in the particular contract will be followed in determining the amount due for its termination when the parties do not settle the claim by agreement, unless the formula fails to provide for fair compensation in accordance with the act. JTR 543, id., C.C.H. ¶ 10,543.


52 Contract Settlement Act, § 6 (g), 41 U.S.C. (1940), Supp. IV, § 106 (g).

contractor should secure the latest termination clauses in his contracts. JTR is very liberal about this and amendment may be made before or after termination.

Generally, the formula will be applied only after diligent efforts have been unsuccessfully made by the parties to negotiate a settlement, or when the prime contractor delays negotiations to the point where interests of subcontractors will be adversely affected. On the other hand, the contractor may demand in writing that the contracting agency make findings on the amount due him on his claim. The contractor is expected to negotiate in good faith, however, for the settlement of his claim before demanding such findings.

Application of the formula to a termination claim takes on a more formal atmosphere than is present in negotiated settlements. Where a settlement is had by formula, the contractor has the burden of establishing, by proof satisfactory to the contracting officer, the amount due him on his termination claim.

At least fifteen days' notice must be given the contractor by the contracting officer to produce, on some stated date, his written evidence relevant to the amount due. The contractor may then submit whatever vouchers, verified transcripts of books of account, affidavits and audit reports, and other documents as he may wish. The contracting officer may require the contractor to submit such additional documents and data as he considers necessary in the particular case, and he may institute whatever accounting and other investigations and audits which he feels are necessary or appropriate. If the contractor wishes to present oral testimony, or if the contracting officer wishes testimony offered on behalf of the government, or by independent experts, the contracting officer, in his discretion, may hold a hearing after giving due notice in writing to the contractor. In all cases the contractor is to be given full opportunity to submit, within a reasonable time, such additional documents, records and other evidence as he deems appropriate to support his claim.

1. The Uniform Termination Article

The uniform termination article was formulated by Messrs. Bernard Baruch and John Hancock, and is inserted in all fixed-price sup-

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54 JTR 751.1, id., C.C. ¶ 10,751.1.
56 JTR 752.1, id., C.C.H. ¶ 10,752.1.
57 JTR 752.2, id., C.C.H. ¶ 10,752.2.
ply contracts placed after January 21, 1944. The formula in this article calls for payment by the government in the following amounts:

1. The contract price for articles completed but not paid for.

2. In respect of the contract work terminated, the total of (i) the cost of such work exclusive of any cost attributable to articles paid or to be paid for under (1) above; (ii) the cost of settling and paying claims arising out of the termination of work under subcontracts or orders exclusive of the amounts paid or payable on account of supplies or materials delivered or services furnished by the subcontractor prior to the effective date of termination; and (iii) a sum equal to — per cent of the part of the amount determined under subdivision (i) which represents the cost of articles or materials not processed by the contractor, plus a sum equal to — per cent of the remainder of such amount, but the total of such sums is not to exceed 6 per cent of the whole of the amount determined to be due under (i). For the purpose of subdivision (iii), any charges for interest on borrowing are to be excluded.

(In other words, the profit allowance will usually be 2 per cent on raw materials and purchased parts, plus 8 per cent on work in process, but the total amount of such profit will not exceed 6 per cent of the value of the raw materials, purchased parts and work in process.)

3. The reasonable cost for protection and preservation of property involved in the termination, plus post termination (settlement) expenses.

For the purpose of computing the allowance for profit, the amounts paid or payable to subcontractors for materials delivered or services furnished by them before the effective date of the termination should be treated as a part of the war contractor's own charges and not as a part of the cost of settling termination claims of subcontractors; nor, as we have seen, may his costs include any charge for interest on borrow-

58 The chief of each technical service may provide for determining the percentage to be inserted at note 58 (which in no event is to exceed 2 per cent) and at note 59 (which may be greater or less than or equal to 6 per cent). The general use of 2 per cent and 8 per cent, respectively, as arbitrary figures is recommended by JTR in the interest of expediting the execution of contracts. Where the use of arbitrary figures is not desired for any reason, the methods to be used in arriving at the percentage to be inserted at note 58 shall be the same as those now used in price analysis. When the intended rate of profit on the finished article covered by the contract is lower than 8 per cent, it has been stated by the War Department that the insertion of a lower figure at note 59 is desirable. In the Navy Department the figures of 2 per cent and 8 per cent are used without variation. See JTR 931, note 1, C.C.H. War Law Serv., Govt. Contracts, ¶ 8001.

59 See note 58, supra.

60 JTR 541.3, id., C.C.H. ¶ 10,541.3.
rowings or for amounts paid by him in settling termination claims of subcontractors.

The total amount payable to the contractor under the formula, before deducting disposal credits may not exceed the total contract price less payments otherwise made or to be made under the contract. From the above amount must be deducted any disposal credits, that is, the agreed price for any termination inventory retained by the war contractor, and the proceeds of sale of any materials sold by him, which have not otherwise been paid or credited to the government or customer.

Under the uniform article for prime contracts, the risk of loss of termination inventory, except for normal spoilage, remains on the prime contractor until transfer of such property to the government or to a buyer, or until sixty days after delivery to the government of an inventory schedule covering it, whichever occurs first, unless the government has expressly assumed such risk. Under the formula, if any of this property is damaged or lost so as to become undeliverable within these periods, any amounts payable for such property are to be deducted from the amounts otherwise payable to the prime contractor. Furthermore, deduction may be made by the government for any other claim which it may have against the prime contractor in connection with the contract. Deductions may also be made for all unliquidated partial or progress payments, payments on account theretofore made to the contractor, and unliquidated advance payments.

2. Principles for Determining Costs

Paragraph (h) of the uniform article states that payments to be made to the contractor under the formula shall be determined in accordance with the "Statement of Principles for Determination of Costs upon Termination of Government Fixed-Price Supply Contracts" which was approved by the Joint Contract Termination Board on December 31, 1943. This Statement was made effective by Directive Orders 1 and 2 of the Office of War Mobilization issued January 8, 1944, and February 24, 1944, respectively. Regulation No. 7, issued

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61 JTR 542.2, id., C.C.H. ¶ 10,542.2.
62 JTR 542.4, id., C.C.H. ¶ 10,542.4. Under the uniform article, the contracting office may deduct the amount of any termination claim of any subcontractor to the extent that it does not cover materials delivered to the contractor, or services furnished to him for the production of completed articles. JTR 542.5, id., C.C.H. ¶ 10,542.5. The prime contractor is entitled to have the withheld sum applied for his benefit in such a way as to exonerate him to that extent from the claims of the subcontractor. JTR 668, id., C.C.H. ¶ 10,668.
by the Director of Contract Settlement on October 5, 1944, affirmed
the validity of the Statement and indicated the extent to which it was

to be taken into account in settlements, whether by formula or by
agreement, while Regulation 5, issued on September 30, 1944, made
certain amendments to it. Finally, to promote uniformity in the
interpretation and application of the Statement of Cost Principles,
Regulation No. 14 was issued on February 22, 1945. ThisRegula-
tion is composed of a number of "Termination Cost Memorandums"
defining and interpreting various words and phrases contained in the
Statement.

As the principles established by the Statement are included in the
Joint Termination Regulation, and since they are important in reach-
ing settlements either by formula or agreement, they are included here
with certain notations:

(1) General Principles

"The costs contemplated by this Statement of Principles are those
sanctioned by recognized commercial accounting practices and are

\[JTR\] 552, id., C.C.H. §10,552. While the discussion in the text and notes
at this point relates to some of the most difficult problems in general and cost ac-
counting, it is necessary that some acquaintance with them by lawyers be established, since
negotiation and litigation will frequently center about these issues.

\[64\] "The termination cost memorandums are intended to serve as guides to per-
sonnel of prime contractors, subcontractors, and contracting agencies in the proper
interpretation of the Statement of Cost Principles wherever that Statement is applicable.
They represent a standard of accuracy and acceptability in the accounting treatment
of the costs to which they relate. However, accounting data may be accepted when
determined on bases different from those set forth in the memorandums if such bases
nevertheless represent recognized commercial accounting practices and yield equitable
results. Where specific methods of accounting treatment are suggested or illustrated by
the memorandums, it is not intended that such methods need be adhered to literally
in all cases. Particularly is this so where the amounts involved are relatively small.
In such cases, especially for purposes of negotiated settlements, the possibility of
greater accuracy to be derived by an exact application of the memorandums may not
justify the increased time and effort involved in their use." Regulation No. 14, 10


\[66\] See Regulation No. 14, Termination Cost Memorandum (hereinafter cited as
T.C.M.) No. 1, 10 Fed. Reg. 2312 at 2313 (Feb. 28, 1945). "For purposes of these
termination cost memorandums, costs and expenses 'sanctioned by recognized commer-
cial accounting practices' are defined as those costs and expenses which are reasonably
incurred in the conduct of a business and are expected to be recovered from the sell-
ing price in customary business transactions . . . Such costs are generally broader in
scope than those ordinarily contemplated in factory cost accounting and those recog-
nized by the Government for purposes of cost-plus-a-fixed-fee contracts. They include,
in addition to direct and indirect factory costs, selling, distribution, administrative,
intended to include the direct and indirect manufacturing, selling and
distribution, administrative and other costs incurred, which are rea-
sonably necessary for the performance of the contract, and are properly
allocable or apportionable, under such practices, to the contract (or
the part thereof under consideration). The general principles set out
in this Statement are subject to the application of any special provisions
of the contract. Certain costs are specifically described below because
of their particular significance, and, as in the case of other costs, should
financial, and general expenses incurred in the conduct of a business."

term 'recognized commercial accounting practices' means anything . . . it must mean
costs incurred by the contractor in good faith in the conduct of his business. Thus it
rules out any such narrow interpretation of applicable costs as has been followed under
accounting for cost-plus-a-fixed-fee contracts."

Some writers doubt that there is any "recognized commercial accounting
practice," at least, when it comes to cost accounting. See, for example, Robert L.
"To be recognized, the accounting practices of a war contractor must be sound
when tested on an objective basis, such as substantial use by similar organization, ac-
ceptance by independent public accountants, or recognition by other authorities . . .
"... Financial statements, tax returns, or other reports prepared by a war
contractor shall be indicative rather than controlling in determining the acceptability
of the accounting practices applied in the preparation of termination settlement pro-
posals.

"The accounting practices followed by a contractor in preparing termination
settlement proposals should be those which it is anticipated will produce acceptable
results when consistently applied, considering the contractor's proposals in the aggre-
gate, rather than those which might be especially suited to a particular termina-
67 T.C.M. No. 2, id., Fed. Reg. 2313. "General, administrative and distribu-
tion expenses" . . . are those expenses incurred in the general management and opera-
tion of a business which are not directly related to production. They may include such
items as: salaries of officers, wages of clerical employees, general office expenses, dues
and memberships, professional fees, financial expenses, and general selling and dis-
tribution expenses." For manufacturers, allocation of these expenses may be made
on the basis of a general rate representing the relation of the total administrative
expenses to the total cost of production for a representative period. The rate so
determined should be applied to the corresponding costs of the contractor included in
its settlement proposal. Where the rate for applying general and administrative ex-
penses was found by dividing the cost of these expenses for a given period by "total
purchases" for the same period, it was held that the rate was improper and that the rate
found by comparing these costs with sales or cost of sales was "reasonable and consistant
with recognized commercial accounting practices." Metal Associates, Inc., War Dept.

Where a contractor sublet the entire contract to a subcontractor and received a
service charge for all units accepted by the government, the Board of Contract Appeals
held a charge presented by the contractor for general and administrative expenses was
not reimbursable. Metal Associates, Inc., supra, this note.
be included to the extent that they are allocable to or should be apportioned to the contract or the part thereof under consideration."

(2) Particular Allowed Items

"(a) Common inventory. The costs of items of inventory which are common to the contract and to other work of the contractor."

(b) Common claims of subcontractors. The claims of subcontractors which are common to the contract and to other work of the contractor.

(c) Depreciation. An allowance for depreciation at appropriate rates on buildings, machinery and equipment and other facilities including such amounts for obsolescence due to progress in the arts and other factors as are ordinarily given consideration in determining depreciation rates. Depreciation as defined herein shall not include loss of useful value of the type covered by subparagraph (f).

(d) Experimental and research expense. General experimental and research expense to the extent consistent with an established pre-war program, or to the extent related to war purposes.

68 T.C.M. No. 3, id., FED. REG. 2312. "Allocation to the contract should be made only to the extent that quantities of the common item on hand, in transit, and on order are in excess of the reasonable, quantitative requirements for other work. . . . However, this principle of allocation is not intended to prevent a war contractor from allocating to the contract properly allocable items which cannot be used on other work without loss to the contractor. As a general rule, a detailed determination of such requirements for other work will not be necessary if there is general evidence that the policy of the contractor is to cover the reasonable requirements of both the contract and other work."

69 Depreciation denotes that part of the cost of a fixed asset which is charged to a particular period on the basis of distributing its cost over its estimated useful life. Depreciation is to be distinguished from "amortization" of special tools, loss of useful life of special facilities and "accelerated depreciation" of emergency facilities under § 124 of the Internal Revenue Code, 26 U.S.C. (1940), Supp. IV, § 124. Any recognized method of depreciation will be allowed, but any variation from previous consistent practice may raise questions "as to the propriety of the depreciation charges as a whole." However, depreciation rates may reflect accelerated depreciation "if the contractor can demonstrate the reasonableness of such accelerated rates in the light of unusually intensive or abnormal use of the related assets." T.C.M. No. 12, 10 FED. REG. 9676 (Aug. 4, 1945).

70 This item refers to expenses incurred on projects of a basic and general nature and in the development of new products and processes, as distinguished from process engineering, tool development and similar activities related to particular contracts. The applicable amount of such expenses is to be measured by its consistency with the contractor's pre-war program unless such program does not provide an adequate basis for comparison, as in the case of newly organized companies. Where the consistency basis is not applicable, the amount of general experimental and research expense to be considered for apportionment between government sales and other work will be limited to such expense as is related to war purposes. T.C.M. No. 14, 10 FED. REG. 9677 (Aug. 4, 1945).
(e) Engineering and development and special tooling. Costs of engineering and development and of special tooling; **Provided,** That the contractor protects any interests of the Government by transfer of title or by other means deemed appropriate by the Government.

(f) Loss on facilities; conditions on allowance. In the case of any special facility acquired by the contractor solely for the performance of the contract, or the contract and other war production contracts, if upon termination of the contract such facility is not reasonably capable of use in the other business of the contractor **72** having regard to the then condition and location of such facility, an amount which bears the same proportion to the loss of useful value as the deliveries not made under the contract bear to the total of the deliveries which have been made and would have been made had the contract and the other contracts been completed: **Provided,** That no amount shall be allowed under this paragraph unless upon termination of the contract title to the facility is transferred to the Government, except where the Govern-

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**71** “Engineering and development” refers to the design of the product, the detailed engineering specifications, the design of special tooling, the planning of production processes and layout, and related functions performed specially for the contract, or the contract and other war production contracts. “Special tooling” includes jigs, dies, fixtures, moulds, gauges, and other similar equipment required or produced by the war contractor. The term does not relate to buildings, building equipment, and machine tools; nor to tools such as cutting tools and hand tools which ordinarily lose their utility through wear and tear rather than through obsolescence. T.C.M. No. 10, 10 Fed. Reg. 9675 (Aug. 4, 1945). This memorandum also refers to “preparatory expenses” which are not mentioned as such in the Statement. These include reasonable costs of plant rearrangement and alterations, organization, planning and similar activities (exclusive of construction of special facilities or incurring of initial costs) carried on specifically for war work.

It should be noted that where tooling or other items are retained by the contractor or sold to a third party, their retention value or the proceeds of any sale should be treated as a disposal credit in the contractor's settlement proposal and not as a reduction of the cost of the special items subject to amortization. The result of this treatment will be a lower cost to the government.

**72** T.C.M. No. 9, 10 Fed. Reg. 3925 (April 11, 1945). “Facilities will be considered ‘reasonably capable of use in the other business of the contractor’ and, therefore, not subject to the loss provisions of the Statement of Cost Principles, so long as they would require only relatively minor changes in their physical condition or location to render them capable of such use in a reasonably economical manner. Those facilities which are physically capable of use in the other business of the contractor will qualify for the loss provisions only if (i) they would require a relatively large expenditure to change their character or location in order to make them capable of economic use or (ii) the character of the facilities would prevent their use in a reasonably economical manner.”

Evidence will have to be produced that a facility is a special facility. In no case will the contractor’s unsupported assertion on this point be considered sufficient, and a representation by the contractor at the time the contract was negotiated that it did
ment elects to take other appropriate means to protect its interests. 73

(g) Special leases. (1) Rentals under leases clearly shown to have been made for the performance of the contract, or the contract and other war production contracts, covering the period necessary for complete performance of the contract and such further period as may have been reasonably necessary; (2) costs of reasonable alteration of such leased property made for the same purpose; and (3) costs of restoring the premises, to the extent required by reasonable provisions of the lease; less (4) the residual value of the lease; Provided, That the contractor shall have made reasonable efforts to terminate, assign, or settle such leases or otherwise reduce the cost thereof.

(h) Advertising. Advertising expense to the extent consistent with a pre-war program or to the extent reasonable under the circumstances. 74

(i) Limitation on costs described in subparagraphs (d), (e), (f), (g) and (h). In no event shall the aggregate of the amounts allowed under subparagraphs (d), (e), (f), (g) and (h) exceed the amount which would have been available from the contract price to cover these items, if the contract had been completed, after considering all other costs which would have been required to complete it. 75

(j) Interest. Interest on borrowings.

not need additional facilities for its performance will indicate that such acquisition was not contemplated.

Where the contracting officer in a formula settlement attempted to determine the estimated future use of the facilities based on the period of national emergency, and thus reduce the cost to the government, it was held that the cost must be determined instead on a percentage of completion of contract basis. The B.C.A. held that appellant was entitled to the total cost of the facilities (after deducting certain improvements not necessary to performance of the contract), less the amount charged to the completed portion of the contract, and less the reasonable value to him of these facilities at the date of termination, Curran Chemical Armes Corp., War Dept. B.C.A. No. 663, C.C.H. WAR LAW SERV., 2 Contract Cases Federal 1119 (1944).

73 Regulation No. 5, 9 FED. REG. 12282 (Oct. 10, 1944), deleted the following words from this section: "... provided that the amount to be allowed under this paragraph shall not exceed the adjusted basis of the facility for Federal Income Tax purposes immediately prior to the date of the termination of the contract...."

74 Nominal advertising expense is to be treated as general, administrative and distribution expense and allocated in accordance with T.C.M. No. 2, 9 FED. REG. 11275 (Sept. 13, 1944). If the amount is greater than a nominal sum, that amount may be allowed which is consistent with the contractor's pre-war advertising. If such a basis is not available the reasonableness of the termination charge will be determined "in the light of the circumstances of each case." T.C.M. No. 13, 10 FED. REG. 9677 (Aug. 4, 1945).

75 T.C.M. No. 5, 10 FED. REG. 2314 (Feb. 28, 1945), "The limitation provided in subparagraph 1 (i) is for application only in those cases where it is determined
(k) **Settlement expenses.** Reasonable accounting, legal, clerical, and other expenses necessary in connection with the termination and settlement of the contract and subcontracts and purchase orders thereunder, including expenses incurred for the purpose of obtaining payment from the Government only to the extent reasonably necessary for the preparation and presentation of settlement proposals and cost evidence in connection therewith.  

(1) **Protection and disposition of property.** Storage, transportation, and other costs incurred for the protection of property acquired or produced for the contract or in connection with the disposition of such property.  

(3) **Initial Costs**

"Costs of a nonrecurring nature which arise from unfamiliarity with the product in the initial stages of production should be appropriately apportioned between the completed and the terminated portions of the contract." In this category would be included high direct labor and
overhead costs, including training, costs of excessive rejections\textsuperscript{79} and similar items.\textsuperscript{79}

(4) Excluded Costs

"Without affecting the generality of the foregoing provisions in other respects, amounts representing the following should not be included as elements of cost:\textsuperscript{80}

(a) Losses on other contracts, or from sales or exchanges of capital assets; fees and other expenses in connection with reorganization or recapitalization, anti-trust or Federal income-tax litigation, or prosecution of Federal income-tax claims or other claims against the Government (except as provided in paragraph (k)); losses on investments; provisions for contingencies; and premiums on life insurance where the contractor is the beneficiary.

(b) The expense of conversion of the contractor's facilities to uses other than the performance of the contract.\textsuperscript{81}

(c) Expenses due to the negligence or wilful failure of the contractor to discontinue with reasonable promptness the incurring of expenses after the effective date of the termination notice.

(d) Costs incurred in respect to facilities, materials or services termination settlements but are to be classified and dealt with in a different manner."

Where initial costs are included in the settlement proposal as a direct charge, they are not to be added in again as part of the overhead.

\textsuperscript{79} T.C.M. No. 8, 10 FED. REG. 2315 (Feb. 28, 1945). "The cost of non-reworkable rejects and the cost to rework rejects into acceptable product are usually included in the unit cost of acceptable product. Where the cost of nonreworkable rejects is included in the unit cost at which acceptable product is stated in the termination inventory, such unit cost should also be reduced by the scrap value of such rejects. The cost of nonreworkable rejects on hand at the time of termination should not be included in the termination inventory."

\textsuperscript{80} Regulation No. 5, 9 FED. REG. 12282 (Oct. 10, 1944), deleted the section of the Statement dealing with renegotiation: "Costs which, as evidenced by accounting statements submitted in renegotiation under § 403 of the Sixth Supplemental National Defense Appropriation Act of 1942, as amended, were charged off during a period covered by a previous renegotiation, may not be subsequently included in the termination settlement if a refund was made for such period, or to the extent that such charging off is shown to have avoided such refund."

This was a controversial section of the original Statement, and not at all easy of application.

\textsuperscript{81} The tax treatment of reconversion costs is set forth in Bureau of Internal Revenue Mimeograph No. 5870, INT. REV. BUL. 1945-12-12060. "If a taxpayer is definitely entitled to compensation or reimbursement for any item of reconversion cost incurred, as, for example, where there is specific provision therefor in an agreement, the amount of the item, to the extent deductible, shall be deducted in computing net income for the taxable year for which the compensation for such item is includible in gross income; and if the compensation or reimbursement is not includible in income,
purchased or work done in excess of the reasonable quantitative requirements of the entire contract."

(5) Use of Contractor's Accounting Methods

"To the extent that they conform to recognized commercial accounting practices and the foregoing statement of principles, the established accounting practices of the contractor as indicated by his books of account and financial reports will be given due consideration in the preparation of statements of cost for the purposes of this article."

(6) Other Costs

"The failure specifically to mention in this statement any item of cost is not intended to imply that it should be included or excluded."82

82 A reasonable amount for salaries of partners and sole proprietors may be included. "The charge for services rendered to the enterprise as a whole by a partner or sole proprietor must be reasonable, taking into consideration (i) the nature and extent of the services rendered; (ii) the general level of compensation of persons in similar positions in organizations of similar size and nature; (iii) the amount of similar charges during the periods prior to the assumption of Government contracts; and (iv) the increase in volume of business due to war contracts." See T.C.M. No. 4, 10 FED. REG. 2314 (Feb. 28, 1945).

Materials acquired prior to the date of contract may be included in termination inventory if there is satisfactory evidence that such materials were usable and were intended to be used on the contract. They are not to be excluded solely because they were acquired prior to the date of the contract. See T.C.M. No. 6, id., FED. REG. 2315.

A reasonable charge may be included in the contractor's claim to cover the expense of severance pay where the contractor is required to make such payment by reason of some statute, by written agreement or by the operation of an established policy which constitutes an implicit agreement. T.C.M. No. 16 (Aug. 24, 1945). But no amount may be included where payment is contingent upon recovery from the government. Severance pay has been defined as "amounts due to employees solely by reason of their involuntary separation (ordinarily termed 'layoff') from the employ of the contractor other than for cause." Severance pay will ordinarily be considered as applicable to the entire length of tenure with the employer and not as directly applicable to any particular contract or terminated portion thereof.

Regulation No. 20, 10 FED. REG. 10985 (Aug. 25, 1945), provides for compensation to employers for payment of wages to employees for work done on August 15 and 16, 1945, and for payment for time off on these two V-J days.

The problem of the inclusion of momentum costs, that is, those costs which will continue after war contracts have been terminated, has recently been raised. See Maurice E. Peloubet, "Notes on War Contracts," 79 JOUR. OF ACCOUNTANCY 486 (1945); Walter F. Titus, "Contract Termination and Momentum Costs," 26 NATL. ASSOC. OF COST ACCOUNTANTS BUL. 1063 (1945).

Ordinarily, cash discounts on purchases, which are defined as reductions in amounts paid to vendors for the purchase of items solely because of prompt payment,
3. Findings

When the contracting officer determines the amount due, he must prepare findings and deliver them to the contractor. These findings must include the following items:

(a) A summary of the costs to be paid under the formula settlement.

(b) A statement of the amount allowed by the contracting officer by way of profit. If the prime contract contains the uniform article, this item of profit should be broken down to show separately (1) the amount allowed with respect to the cost of articles or materials not processed by the contractor, and (2) the amount allowed with respect to other costs of the contractor. If the contract contains any other form of termination article, the contracting officer will include in the findings a statement showing the method used in computing the profit allowed in accordance with the contract provisions.

(c) A supporting analysis of disposal credits.

(d) A list of all subcontract settlements.

(e) A list of post termination expenses.

(f) The total amount found to be due the contractor.

These findings then become the basis for payment or suit under the Contract Settlement Act.

4. Payment after Formula Settlement

Whenever a contract is settled by the formula method the Contract Settlement Act requires that at least 90 per cent of the amount which is determined to be due the contractor be paid within thirty days after the delivery of findings to him. Before approving such payments, the contracting officer may require that the contractor submit a duly certified voucher or invoice therefor. Final payment will be made when the claim is determined conclusively by findings or decision.

are to be treated as deductions from contractor's costs of inventory. T.C.M. No. 15, 10 Fed. Reg. 9676 (Aug. 4, 1945).

83 JTR 754, C.C.H. War Law Serv., 1 Govt. Contracts, ¶ 10,754.

84 In making a formula settlement the contracting officer is not to re-examine settlements made with subcontractors with his previous approval nor any other actions (such as property disposal) done with his approval before or after the breakdown of negotiations. JTR 753.2, id., C.C.H. ¶ 10,753.2.

85 Section 13 (a), 41 U.S.C. (1940), Supp. IV, § 113(a); JTR 758.1, C.C.H. War Law Serv., 1 Govt. Contracts, ¶ 10,758.1.
5. Settlement (Post Termination) Expenses

Under paragraph (c) of the uniform termination article the contractor and the contracting officer may agree upon the amount to be paid for post termination expenses and settlement costs. If the parties are unable to agree upon the amount to be paid, the amount will have to be established by the contracting officer as part of the formula settlement under paragraph (d) (3) of the article.86 The Contract Settlement Act assures payment of reasonable costs and expenses of settling termination claims of subcontractors related to the terminated portion of the war contract when the settlement is by determination.87

The problem is primarily one of record keeping. When settlement expenses are to be included in a claim, they should not be included in the overhead rates which are also applied to the claim. Post termination items may be set up in the books of account by contract number and should be segregated from other overhead items. Some contractors, rather than segregate these expenses, may find it practicable not to include any post termination expenses at all, simply recovering them indirectly through regular applications of overhead. However, where they have been included in the claim, no profit may be taken on the amount. No matter what method is used to allocate settlement expenses, the cumulative amount included for these expenses in all termination settlements to date should not exceed the cumulative total of such expenses actually incurred, and the total amount included in any single termination settlement proposal should not exceed an amount reasonably necessary to settle the contract in question.

Where a contractor incurs reasonable preliminary expenses to plan or prepare in advance for terminations, such expenses may be allocated on any fair basis to contracts terminated thereafter.88

87 Section 6 (d) (2), 41 U.S.C. (1940), Supp. IV, § 113(a). Where legal expenses are incurred because of an appeal from a formula settlement, such expenses being in the nature of litigation against the government, will not be allowed under the uniform termination article. Metal Associates, Inc., War Dept. B.C.A. No. T-1048, C.C.H. War Law Serv. 1039 (1945); Curran Chemical Arms Corp., War Dept. B.C.A. No. 663, C.C.H. War Law Serv., 2 Contract Cases Federal 1119 (1944). Where, however, such expenses are connected with the settlement, but prior to the time an appeal is filed therefrom, they are reimbursable. Curran Chemical Arms Corp., War Dept. B.C.A. No. 663, C.C.H. War Law Serv., 3 Contract Cases Federal 273 (1945).
Normally, subcontractors have no contractual rights directly against the government upon the termination of a prime contract. The rights of such contractors are against the prime contractor or intermediate subcontractor who is directly obligated to them on the subcontract which they hold, and the extent of those rights depends entirely upon the terms of the subcontract in question. However, the government under certain circumstances may undertake to settle the claims of subcontractors directly.

Mention of a uniform subcontract article has been made, and it was noted that it contained a formula similar to that in the prime contract article. Where this article is present no new principles are applicable. Subcontracts may be amended to insert the article. While each settlement will be governed to a great extent by the termination provisions, or lack of them, in agreements between customers and suppliers, it will also tend to be limited by the provisions of Regulation No. 7 and the Joint Termination Regulation. Thus, where the approved subcontract termination article is used, the term "recognized commercial accounting practices" as used therein, will be considered as equivalent to the declarations found in the Statement of Cost Principles.90 Other governmental policies applicable to the uniform termination article will also be considered to apply to the subcontract article, as, for example, the policy against reimbursing contractors at the contract rate on termination for completed undelivered articles which represent unreasonable anticipation of production schedules and the policy against taking advantage of technical defaults when the real reason for termination is the termination of a prime contract by the government.90

When the subcontract does not contain the uniform article, a settlement based upon a reasonable estimate by the parties of the aggregate amounts which would be due under that article will be considered fair and reasonable. Or any settlement reached in conformance with the principles stated above for the negotiation of claims will be acceptable.91

In some instances, because of the terms of the particular subcon-

89 JTR 552.1 (3), id., C.C.H. §§ 10,552.1.
90 JTR 621, id., C.C.H. §§ 10,621.
91 JTR 624, id., C.C.H. §§ 10,624.
tract being settled, the government will be under an obligation either
to make reimbursement for, or to assume the defense against, a demand
by a subcontractor which is greater in amount than would be recog-
nized under application of the principles in the last paragraph. On
submission to the contracting officer for his approval of a settlement
which provides for the payment of such an amount, the contracting
officer will decide whether the settlement should be approved or rati-
fi ed, or whether the government should protect the prime contractor
or intermediate subcontractor from the asserted liability. In general,
the contracting officer will recognize the settlement where the terms of
the subcontract were negotiated in good faith and do not unreasonably
increase the rights of the subcontractor.

In certain cases a judgment obtained by a subcontractor against his
customer will be considered as binding against the government. In
the case of any subcontract which does not contain unusual termination
provisions unreasonably increasing the rights of the subcontractor, and
in which the prime contractor, after making unsuccessful efforts to
settle with his subcontractor, is sued in a court of competent jurisdi-
cation, gives prompt notice to the contracting agency involved and offers
to the agency the control of the defense of the suit, the agency should
accept any final judgment as determining the amount of the govern-
ment's obligation to reimburse the prime contractor, to the extent that
the subcontract is properly allocable to the prime contract. The propri-
ety of this allocation remains for the determination of the contracting
agency.92

It will be seen that the problem which is being attacked here is the
measure of damages in the absence of a specific termination article. The
supplier is entitled under the common law to the profit he would have
received if the contract had run to completion.93 But the uniform
prime contract article does not provide for anticipated profit, nor does
the subcontract article. The question of damages would not seem to
be closed by any laws or regulations which have been promulgated, and
what action or attitude will be taken by each individual subcontractor
is apparently a question of individual policy.

Possibly, it has been suggested, subcontractors would be willing to
forego their common law rights if they could be assured of substantial
and speedy payment of their termination claims. The Contract Settle-

92 Office of War Mobilization Director, Order No. 4, May 2, 1944; JTR 625.1,
C.C.H. WAR LAW SERV., 1 Govt. Contracts, § 10,625.1.
93 25 C.J.S., § 74.
ment Act has gone a long way to extend such assurance to subcontractors, as may be seen in the following discussion.

One risk which the subcontractor faces which the prime contractor does not face is the possible insolvency of his customer. Before the passage of the Contract Settlement Act, the War Department's Procurement Regulation 15 provided that partial payments for the benefit of the subcontractor be handled in such a manner that they could not be reached by the prime contractor or his creditors.\(^4\) Greater protection, however, is afforded by the act, for it provides that whenever the contracting agency is satisfied that the prime contractor is unable to meet his obligations the agency is to supervise or control payments to the prime contractor in such manner as it deems best for the benefit of the subcontractor.\(^5\) Methods of supervision or control which may be employed include payment through a trustee or escrow agent, and the deposit of funds in a special account from which withdrawal is subject to approval or countersignature by a government representative.

If insolvency of the prime contractor occurs after he has received payment, but before he has paid the subcontractor the amount of his charge, the act empowers the contracting agency to pay the amount of the charge to the subcontractor directly, even though it involves payment of the same debt twice.\(^6\) Payments will be made under this part of the act only when the contracting agency determines that it is not reasonably practicable for the subcontractor to secure fair compensation for the termination of his subcontract from the war contractor liable to him or from any other party, or by protected payments, or by direct settlement.\(^7\) Furthermore, before any payment may be made under these provisions, the contracting agency must determine "that in the circumstances of the particular case equity and good conscience require"

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\(^4\) P.R. 15-507 (2), (now replaced by JTR) provided for payments in trust for the benefit of the subcontractor or supplier, no matter how remote. See JTR 668, C.C.H. War Law Serv., 1 Govt. Contracts, ¶ 10,668.


\(^6\) Section 7 (f), 41 U.S.C. (1940), Supp. IV, § 107(f); such payment is limited to fair compensation and does not include payment on account for completed articles delivered or services performed pursuant to the subcontract or on account of any other claim that may arise under the terminated contract. JTR 652.2, C.C.H. War Law Serv., 1 Govt. Contracts, ¶ 10,652.2.

\(^7\) Regulation No. 17, ¶ 5, 10 Fed. Reg. 6250 (May 29, 1945); JTR 652.3, C.C.H. War Law Serv., 1 Govt. Contracts, ¶ 10,652.3.
**Terminated War Contracts**

1. **Terminated War Contracts**

   "The determination will call for the exercise of sound judgment on the facts of each case. For example, many contractors, at the instance of representatives of a contracting agency and in order to expedite war production, assumed risks in dealing with previously unknown or with over-extended customers, contrary to their normal peace-time practice. In such cases, considerations of fairness may make it appropriate for the contracting agency to make payments to subcontractors who could not otherwise obtain fair compensation for the termination of their subcontracts. On the other hand, the contracting agencies are not expected to make payments under this section to subcontractors who incurred the risk of non-payment in the course of normal business dealings."  

   The subcontractor may have to overcome another obstacle when, for one reason or another, he cannot reach a settlement with his prime contractor or the subcontractor immediately above. Section 7 (d) of the Contract Settlement Act authorizes the contracting agencies to settle directly termination claims of subcontractors to the extent that such action is deemed necessary or desirable for the expeditious and equitable settlement of such claims. Likewise, whenever any contracting agency is satisfied that a war contract is, or is in serious danger of becoming, unable to meet his obligations, and it considers that protected payments would fail to assure prompt payment of the termination claims of his subcontractors, the contracting agency will settle directly the termination claims of such subcontractors, where it would otherwise be required to bear the cost of settling the terminated subcontract. (Direct settlement with a subcontractor may be made without regard to any assignment by, or insolvency or bankruptcy of, higher tier war contractors, and without regard to setoffs between contractors in the contractual chain. Such direct settlement is to be made without deduction for claims which the government may have against the prime contractor or any other higher tier war contractor, although

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68 41 U.S.C. (1940), Supp. IV, § 107(d). The director has ruled that the words "settle directly" refer to "(1) the negotiation or determination by a contracting agency of the amount due on account of the termination claim of a subcontractor and the payment of such amount to the subcontractor, or (2) the payment to a subcontractor of the amount which has been determined to be due on his termination claim by a settlement which was made under any other authorized procedure and adopted and assumed by the contracting agency." Regulation No. 17, ¶ 3 (b), id., Fed. Reg. See also Regulation No. 16, "Program for Limited Company-Wide Settlement of Termination Claims," 10 Fed. Reg. 6249 (May 29, 1945), as supplementing the principal method of negotiation of contract settlements between the parties thereto.
a contracting agency may protect any setoffs which the government may have against the subcontractor with whom direct settlement is made.) Direct settlement with a subcontractor may be made without regard to any limitation on the amount payable by the government to a prime contractor.

In general, in any case where direct settlement with subcontractors is undertaken under the act or because of contract provisions permitting such action, the settlement procedures specified for settlements with prime contractors will be followed to the extent applicable. Therefore, in the case of the final settlement for use after complete termination, all claims, rights and obligations of either party (other than those expressly excepted or reserved) arising under the terminated war contract should be discharged and released by the agreement, unless the settlement is limited to fair compensation. In addition, the contracting agency must secure a release of the subcontractor's claim against the war contractor liable to him or an assignment thereof to the government, or it may take such other action as is deemed appropriate to protect the interests of the government. (Payments under such settlements must be made consistently with the terms of any assignment executed by the subcontractor with whom the settlement is made, of which the disbursing officer has knowledge.)

The fact that agreement cannot be reached on one or more subcontractors' claims by the prime contractor or the government is no reason why the termination cannot be settled excluding the amounts due these subcontractors. JTR provides that settlements may be so effected leaving to a later date the settlement of undecided claims. Similar arrangements may be made, with the written consent of the prime contractor and of all intervening subcontractors, when a subcontractor of any tier cannot make settlement with one or more subcontractors of the next tier below him.

Similarly, no subcontractor should be called upon to wait for other subcontractors to present their claims before his own claim can be settled. While this frequently happens, the Joint Termination Regulation specifically states that "a war contractor should promptly transmit up the contractual chain all his settlements with his subcontractors which require approval by the Government," and that a partial payment should be obtained on behalf of the subcontractor.

99 JTR 663.1, C.C.H. WAR LAW SERV., 1 Govt. Contracts, ¶ 10,663.1
100 JTR 613, id., C.C.H. ¶ 10,613.
Interest on termination claims is now allowed by the Contract Settlement Act. Interest on the amount due on the termination claim begins to run at 2½ per cent per year for a period beginning on July 21, 1944, or thirty days after the date fixed for termination (not from the date of presentation of the claim), whichever is later, and ending with the date of final payment. The phrase "the date fixed for termination" means either the date the contractor is ordered to stop or reduce deliveries, or if no deliveries are being made, to stop or reduce performance under the contract.

For the purpose of computing interest, the term "amount due on the termination claim" means the amount determined to be due for fair compensation for the termination of the contract, less: (1) the amount of any credits for retention or disposal of termination inventory; and (2) amounts paid or payable to subcontractors, except to the extent that payment is made by the prime contractor out of his own funds.

There are certain important conditions relating to the computation of interest:

1. Interest will commence to accrue on partial or final payments made by the prime contractor to subcontractors out of the prime contractor’s own funds, as of the date of payment. In applying this provision, funds furnished by the government to the prime contractor for the purpose of making payments to subcontractors shall not be considered as the prime contractor’s own funds.

2. Interest will cease to accrue on the amount due on the termination claim to the extent, and as of the date, of advance, progress or partial payments made on account of such claim after termination.

3. Interest will not accrue on the amount due on the termination claim to the extent, and for the period, that any advance, progress or partial payment made on account of the contract prior to termination remains unliquidated, where, under the terms of such payment, the contractor was not at any time liable for interest thereon.

4. If the contractor unreasonably delays submission and settle-

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102 Section 6 (f), 41 U.S.C. (1940), Supp. IV, § 106(f).
103 JTR 572.1, C.C.H. War Law Serv., 1 Govt. Contracts, ¶ 10,572.1; JTR 121.6, id., C.C.H. ¶ 10,121.6.
104 JTR 572.2, id., C.C.H. ¶ 10,572.2.
105 JTR 572.3, id., C.C.H. ¶ 10,572.3.
ment of his claim, no interest will accrue for the period of the delay. Ordinarily, a period of sixty days is considered reasonable for submission of the claim, and a longer period is considered unreasonable delay, unless the contracting officer determines otherwise.

(5) If the contractor appeals or sues after a formula settlement, interest will cease to accrue thirty days after the delivery to him of the findings, unless the amount allowed by the findings is increased upon appeal or suit.

The settlement agreement will include in the amount payable under the agreement the interest payable on the prime contractor's claim and interest allowable for the claims of his subcontractors. In any case, disputes as to the computation of interest may be settled by agreement. The settlement agreement will release all other claims of the contractor for interest on the termination claim.

V

“No-Cost” Settlements

A no-cost settlement is one in which the contractor waives or releases all claim to compensation for the contract termination. No-cost settlements may be made in the event of either partial or complete terminations and in terminations between the government and prime contractors or between war contractors and lower tier subcontractors. They may also be designated “no-cost” even though the contractor reserves or retains a claim for compensation in respect of one or more particular items.

Prior to the end of the war these settlements were frequently adopted because of the desire to eliminate troublesome problems of cost allocation and preparation of claims. The existence of renegotiable profits, the ability to shift termination inventories with some degree of ease to other war production, and the anticipation of deducting expenses or losses in the computation of income taxes were some of the favorable features of no-cost settlements. However, as these features fade away because of the end of the war the number of claims that will have to be settled with cost will increase.

106 JTR 573, id., C.C.H. ¶ 10,573.
107 Collector's Mimeograph No. 5897 (Bureau of Internal Revenue), ¶ (c) issued July 24, 1945. No. 5897 is a restatement of, and addition to, Mimeograph No. 5766, issued November 1, 1944. See note 101, infra.
For suggested accounting procedure, see “Accounting Research Bulletin No. 25,” issued by the Committee on Accounting Procedure of the American Institute of Accountants, 79 JOUR. OF ACCOUNTANCY 395 (1945).
There is no accruable income from a no-cost settlement, and if such income has been included in a tax return the contractor may adjust the return at any time within the period prescribed by the statute of limitations, regardless of when the no-cost settlement was made.\textsuperscript{108}

\textsuperscript{108} Collector's Mimeograph No. 5897, \S \ (c) \ (1). "Regardless of when the no-cost settlement is made, the determination of what articles are properly includible in the closing inventory of any subsequent year, and the valuation of such articles for inventory purposes, are to be made without regard to any right of the contractor to compensation for termination of a contract terminated prior to the inventory date." \S \ (c) \ (3).

\textbf{Treatment of Compensation for Taxation Purposes.} In addition to problems of securing compensation for terminated war contracts, there arise problems of treatment of such compensation for income tax purposes. A few of the principal rules are mentioned here, but a thorough discussion will be found in the above-cited Collector's Mimeograph. As it stands now the Mimeograph applies to all terminated contracts, no matter how settled.

As to the period when income is returnable, a distinction must first be made between the cash basis and the accrual basis of filing returns. If the return is filed on the cash basis the compensation for terminated contracts is income in the year in which it was received, no matter when the termination occurs. See T.D. 5405, INT. REV. BUL. 1944-19-11861. When the return is rendered on the accrual basis a distinction must be made as to the time of termination. If termination of a war contract occurred within a taxable year ending before July 21, 1944 (the effective date of the Contract Settlement Act), then compensation for the termination must be included in computing gross income for the taxable year in which the claim is allowed, or for the taxable year in which its value is otherwise definitely determined, or for the first taxable year ending after July 20, 1944, whichever year is the earliest. However, no income for such year need include any part of income from a contract termination which was included in income for the taxable year of the termination. This rule applies in all cases of terminated war contracts.

On the other hand, if a war contract is terminated within a taxable year ending on or after July 21, 1944, the income from the termination must be included in computing gross income for the taxable year of the contract termination itself. This rule also applies in all cases of terminations, unless the commissioner rules otherwise. If the income from the termination is not definitely known at the time of filing, a reasonable estimate may be made, and an adjustment in the return taken when the sum is learned.

We have seen that in a negotiated lump sum settlement no part of the compensation is given in payment of any particular item of cost, property, expense or loss. The lump sum covers the claim as a whole, with such exceptions as may be agreed upon by the parties. In these excepted cases there must be excluded from income that part of the compensation which \(1\) is for such excepted items and \(2\) is to be applied in reduction of the cost or basis of such item, or if such item is deductible, is includible in income for the taxable year in which such item is incurred. Such reduction in basis must be made as of the effective date of the termination. Furthermore, the compensation which is to be treated as having been received pursuant to a negotiated settlement does not include any amounts determined as fair compensation \(1\) by the contracting agency pursuant to intra-agency appeal in accordance with the Contract Settlement Act, § 13 \(a\), 41 U.S.C. (1940), Supp. IV, § 113\(a\); \(2\) by the Appeal Board; \(3\) by arbitration; or \(4\) by any court. With respect to amounts determined by the
The contractor may, of course, deduct any item which is allowable as a deduction under the provisions of the Internal Revenue Code. However, the execution of a no-cost settlement does not alone establish for the contractor a right to deduct for any particular year any item not otherwise allowable in computing net income for such year. Rather, the deductibility of any item is to be determined upon the basis of all the pertinent facts and circumstances and irrespective of whether a no-cost settlement is or is not reached.

VI

EFFECT OF CONTRACT TERMINATIONS ON RENEGOTIATION

Receipts or accruals of income as a result of a settlement by negotiation or formula, whether of a prime or subcontract, under the Contract Settlement Act are subject to renegotiation. However, if they were received or accrued with respect to a terminated contract which is exempt or has been exempted from renegotiation, the settlement agreement or determination is exempted from renegotiation pursuant to proper authority. These amounts will be deemed to have been received or accrued to the extent, and in the fiscal year for which, such amounts are estimated, upon the basis of the circumstances existing at the time of renegotiation to be includible in the computation of taxable income under the Internal Revenue Code. Renegotiation will not be postponed or delayed pending the settlement of a termination claim whether by a "no-cost" waiver, or otherwise.

Costs allocable to the uncompleted portion of any terminated contract will be allowed as items of cost in renegotiation unless allocable last-named methods, the contractor may show and the commissioner may determine the portion which is for, in reimbursement of, or attributable to, any particular item of property, cost, expense or loss.

Generally, items which are deductible in computing net income and which for contract termination purposes are allocable to the uncompleted portion of a terminated contract are deductible in computing net income for the taxable year for which the income from the contract termination is includible in gross income. (a) (6).

See note 81, supra, on tax treatment of reconversion costs.

109 Renegotiation Regulations, § 308, C.C.H. War Law Serv., 1 Govt. Contracts, § 5308. The Renegotiation Regulations have been adopted by the War Contract Price Adjustment Board and control the renegotiation of contracts and subcontracts pursuant to § 403 of the Sixth Supplemental National Defense Appropriations Act, 1942, 66 Stat. L. 226, as amended, with respect to renegotiation for fiscal years ending after June 30, 1943.

110 Data on terminations, if amounts are large, must be segregated from other receipts or accruals subject to renegotiation. Renegotiation Regulations, cited supra, note 109, § 308.3, C.C.H. War Law Serv., 1 Govt. Contracts, § 5308.3.
to a terminated contract which is exempt or has been exempted from renegotiation, or the determination or the settlement agreement arising out of the claim has been exempted from renegotiation. Such costs will be allowed, however, only to the extent, and for the fiscal year for which, they are estimated to be deductible in the computation of taxable income under the Internal Revenue Code and will not be allowed to the extent theretofore allowed as items of cost in a previous renegotiation. It will not be necessary to segregate these costs allocable to the uncompleted portions of terminated contracts from other costs allocable to renegotiable contracts unless the costs allocable to the uncompleted portions of terminated contracts constitute a substantial proportion of all of the contractor's costs allocable to renegotiable contracts and the nature or proportions of such costs are substantially different from the nature or proportions of costs allocable to completed contracts or the completed portions of contracts (e.g. the ratio of material costs to direct labor is substantially different).

Where a segregation of the items allocable to the uncompleted portions of terminated contracts is made in accordance with the above principles, separate consideration will be given to such items, in the light of the applicable statutory factors in determining excessive profits. The evaluation so made of the contractor's performance with respect to the uncompleted portions of terminated contracts and subcontracts will be taken into consideration with the evaluation of the contractor's performance of the completed portions of such contracts and subcontracts and other contracts and subcontracts in determining the excessive profits, if any, of the contractor for the period involved in the renegotiation.

"The evaluation of the contractor's performance with respect to the uncompleted portions of terminated contracts and subcontracts will be measured by the nature and extent of such performance. The more nearly the nature and extent of such performance approximate the nature and extent of the contractor's performance of completed contracts and subcontracts of the same type, the more nearly the evaluation of such performance will approach that given to the contractor's performance of completed contracts and subcontracts of the same type. On the other hand, if, for example, the contractor's performance under

111 Renegotiation Regulations, cited supra, note 109, § 381.5, id., C.C.H. ¶ 5381.5. The settlement agreement will specifically reserve all rights and liabilities, if any, of the government and the prime contractor under the Renegotiation Act. JTR 743.1, id., C.C.H. ¶ 10,743.1.

112 Renegotiation Regulations, cited supra, note 109, § 408, id., C.C.H. ¶ 5408.
the uncompleted portions of terminated contracts and subcontracts has consisted largely of the acquisition of inventory which he has processed only slightly or not at all, then the value placed upon such performance must be expected to be substantially less than the value of the contractor's performance in processing such inventory into finished articles delivered under completed contracts and subcontracts. Essentially the problem is no different from that involved in evaluating the contractor's performance under contracts or subcontracts the performance of which has been affected by cutbacks, changed requirements, etc., resulting in inventory losses or write-downs allocable to renegotiable business but with respect to which the contractor had no termination claim or other right to reimbursement."