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## AN OUTLINE OF PROCEDURES IN TERMINATION OF WAR CONTRACTS

H. R. BORTHWICK\*

Termination of war contracts as currently discussed in the press and at meetings of various business and professional groups refers to the termination of fixed-price supply contracts for the convenience of the government, and the consequent determination of amounts allowed contractors or subcontractors for costs incurred and profits earned on uncompleted contracts.

Tactical and strategic developments have already led to some cutting back of procurement of certain articles and cancellation of contracts. Terminations which have occurred are insignificant compared with what will occur upon cessation of hostilities, or sooner. The magnitude of the problem can hardly be overemphasized. If plants are to get back quickly to making civilian goods, if labor is to be employed, termination must be disposed of quickly. Payments must be made. But before payments can be made or plants cleared, claims have to be filed. And before claims are filed, they have to be prepared.

Contractors and their attorneys and accountants should lose no time in preparing for termination. On the Government side, the War Department is taking the lead in termination matters by conducting schools on termination and promulgating manuals and other documents based on studies of the problem.<sup>1\*</sup>

Recently a tentative bill was drawn up by the Senate Military Affairs Subcommittee on Contract Termination. Under the bill, an Office of Contract Settlement is established to formulate administrative policies, draft uniform termination clauses, promote company-wide settlements, and to set up the machinery for appeals. The following features are included in the bill:

(1) Negotiated termination settlements would continue to be made by government procurement agencies, and such settlements could not be reversed or changed without court approval.

(2) In the absence of fraud, government officers would not be personally liable for excess payments made in settlement of claims.

(3) Prime contractors would be encouraged to negotiate settlements with subcontractors; or the government procurement agency

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<sup>1\*</sup>The following are among the basic documents on termination: Procurement

might, with the consent of the prime contractor, negotiate directly with the subcontractors.

(4) Mandatory advance payments to prime contractors within 30 days after submission of claims. Advance payments to subcontractors are also provided for.

(5) Provision for termination loans through banking institutions.

The Director of War Mobilization issued under date of January 8, 1944, a directive to all procurement agencies making immediately effective a Uniform Article for the Termination of Government Fixed-Price War Supply Contracts, and a Statement of Principles to be followed by such Department in determining costs.

The directive was based upon a recommendation by Mr. Bernard M. Baruch and Mr. John Hancock. Mr. Baruch is in charge of the Special Unit in the Office of War Mobilization established by Director Byrnes to deal with War and Post War Adjustment problems. Mr. Hancock is associated with Mr. Baruch in that work and is Chairman of the Joint Contract Termination Board composed of representatives of the various departments, which Board has agreed to the Article and the Statement of Principles made effective immediately for all departments.

It is stated in the directive order issued to all procurement agencies by Director Byrnes that the termination article shall be used to the fullest extent practicable in all new war contracts and contractors shall be given the earliest practical opportunity to have the article included in existing contracts, and that situations in which it is deemed impracticable to use the termination article are to be promptly reported to the War Mobilization Director for further instructions.

The contract termination clause follows closely the standard clause which the Army has been using for all of its contracts for some time.<sup>2\*</sup>

Regulations No. 15, War Department, Headquarters, A. S. F. (Army Service Forces), Washington, D. C., issued August 14, 1943; TM 14-320, War Department Termination Accounting Manual for Fixed-Price Supply Contracts, prepared by the Office of the Fiscal Director, Headquarters, A. S. F., issued July 7, 1943. The latter succeeds the Army Ordnance Department's "Termination Manual." Other important documents are Army Ordnance Report No. 2., August 9, 1943, and excerpts from a statement by Under Secretary of War Patterson November 8, 1943, before the Murray Subcommittee on Contract Termination of the Senate Military Affairs Committee. Also recommended is the printed report of the Contract Termination Conference of the Automotive Council, held in Detroit on September 28, 1943. It seems probable that there will be a uniform manual of termination accounting for all services, but it has not yet been promulgated.

<sup>2\*</sup>"UNIFORM TERMINATION ARTICLE FOR FIXED PRICE SUPPLY CONTRACTS.

"Article *Termination at the Option of the Government.* (a) The performance of work under this contract may be terminated by the Government in accordance with this Article in whole, or from time to time in part, whenever the contracting officer shall determine any such termination is for the best interests of the Government. Termination of work hereunder shall be effected by delivery to the contractor of a Notice of Termination specifying the extent to which performance

Where the sums involved are insignificant or the time of contract is short, the termination article may not be needed.

of work under the contract shall be terminated, and the date upon which such termination shall become effective. 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 may by the \_\_\_\_\_ 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.

"(b) After receipt of a Notice of Termination and except as otherwise directed by the contracting officer, the contractor shall (1) terminate work under the contract on the date and to the extent specified in the Notice of Termination; (2) place no further orders or subcontracts for materials, services or facilities except as may be necessary for completion of such portions of the work under the contract as may not be terminated; (3) terminate all orders and subcontracts to the extent that they relate to the performance of any work terminated by the Notice of Termination; (4) assign to the Government, in the manner and to the extent directed by the contracting officer, all of the right, title and interest of the contractor under the orders of subcontracts so terminated; (5) settle all claims arising out of such termination of orders and subcontracts with the approval or ratification of the contracting officer to the extent that he may require, which approval or ratification shall be final for all the purposes of this Article; (6) transfer title and deliver to the Government in the manner, to the extent and at the times directed by the contracting officer (i) the fabricated or unfabricated parts, work in process, completed work, supplies and other material produced as a part of, or acquired in respect of the performance of, the work terminated in the Notice of Termination, and (ii) the plans, drawings, information and other property which, if the contract had been completed, would be required to be furnished to the Government; (7) use his best efforts to sell in the manner, to the extent, at the time, and at the price or prices directed or authorized by the contracting officer, any property of the types referred to in subdivision (6) of this paragraph provided, however, that the contractor (i) shall not be required to extend credit to any purchaser and (ii) may retain any such property at a price or prices approved by the contracting officer; (8) complete performance of such part of the work as shall not have been terminated by the Notice of Termination; and (9) take such action as may be necessary or as the contracting officer may direct for protection and preservation of the property, which is in the possession of the contractor and in which the Government has or may acquire an interest.

"(c) The contractor and the contracting officer may agree upon the whole or any part of the amount or amounts to be paid to the contractor by reason of the total or partial termination of work pursuant to this Article, which amount or amounts may include a reasonable allowance for profit, and the Government shall pay the agreed amount or amounts. Nothing in paragraph (d) of this Article prescribing the amount to be paid to the contractor in the event of failure of the contractor and the contracting officer to agree upon the whole amount to be paid to the contractor by reason of the termination of work pursuant to this Article shall be deemed to limit, restrict or otherwise determine or affect the amount or amounts which may be agreed upon to be paid to the contractor pursuant to this paragraph (c).

"(d) In the event of the failure of the contractor and contracting officer to agree as provided in paragraph (c) upon the whole amount to be paid to the contractor by reason of the termination of work pursuant to this Article, the Government, but without duplication of any amounts agreed upon in accordance with paragraph (c), shall pay to the contractor the following amounts:"

(Then follow the cost formula, paragraph (e) relating to payments by the Government, paragraph (f) relating to equitable adjustment in prices for work not terminated, paragraph (g) relating to partial payments, and paragraph (h) relating to the Statement of Principles for Determination of Cost upon Termination of Government Fixed-Price Supply Contracts.)

A choice between two types of settlement is provided for: (1) negotiated settlement wherein the Government and the contractor agree upon a fair and reasonable settlement, or (2) settlement through application of a cost-and-profit formula which is to be applied in case the parties are unable to arrive at a negotiated settlement. The profit formula limits aggregate profit in all cases to a maximum of 6%, and limits to a maximum of 2% the profit on unfinished inventory, and that only to the extent that such inventory is properly allocable to the contract. Contractors should be extremely cautious about building up inventories in anticipation of contracts not yet formally executed. Procurement officers will naturally tend to urge contractors to anticipate needs as long as the urge is for increased production, but when the situation changes and terminations take place, contracting officers may be expected to disclaim responsibility for inventories beyond the immediate needs of the contracts.

In both the negotiated settlement (paragraph (c) of termination article) and the formula settlement (paragraph (d)) provided in case of failure of negotiated settlement, the contracting officer is given great discretionary powers. The Statement of Principles for Determination of Costs which accompanies the termination article is for use under paragraph (d), the formula settlement provision of the termination article.

The War, Navy and other departments have able personnel in charge of these matters. Many of them are prominent business and professional men who are patriotically serving at a fraction of their normal earning power. The procedure has been good. The Termination Accounting Manual, for example, has been developed in close cooperation with a committee of the American Institute of Accountants.

The Controller General is reported as insisting upon detailed auditing of all termination claims by the General Accounting Office prior to final settlement. It is not the purpose of this article to deal with this controversial subject, but to give an outline of termination procedure and of sources of information on the subject.

The main objectives in termination procedure are (1) to get all the money rightfully due, (2) to get it quickly, and (3) to clear all plants of government property so that peace-time production may speedily be resumed.

First and most important, each contractor or subcontractor should designate someone in his organization to handle and be responsible for contract termination. The job of termination will carry through the reconversion period into the peace-time period when executives will be needed on their regular jobs. In a business concern of any size, termination will be a full-time job for at least one man. The task

requires skill in customer contacts, vendor contacts, material handling, legal and accounting functions. The accounting and legal functions predominate.

The accountant's greatest usefulness will be in his traditional field of independent and objective auditing and reporting, and of assisting and advising contractors on matters of accounting and cost computation. The lawyer should be the advocate, and should handle all matters dealing with the legal aspects of contracts, termination clauses and settlements. He should see that the contractor's legal rights are duly and adequately protected, consistent with protection of the public interest.

The second step is a thorough analysis of all sales contracts as to termination clauses. If any of them contain provisions for settlement by formulas, prompt action should be taken to have the contract amended to permit settlement by negotiation. It is my understanding that the procurement agencies are more than willing to substitute a standard clause calling for negotiated settlement. The Army Ordnance Report of August 9, 1943, contains an interesting discussion of the advantages of this clause. It contains the following quotation from the Under Secretary of War:

"To the end that contractors, whose contracts are terminated for the convenience of the government, may receive prompt payments of amounts due to them and thus may be assisted in undertaking other productive work at the earliest possible moment, liberal use will be made of the authority granted by the annexed regulations to amend contracts, even after notice of termination has been given, to permit a negotiated settlement of the amount due by reason of termination."

The alternative to negotiated settlement is settlement by formula, which is liable to be slow and troublesome and subject to detailed audit by the General Accounting Office.

The negotiated settlement is said to be based upon a common law principle that private contracting parties may compromise and settle certain claims and counterclaims according to their sound business judgment, exercised in good faith, and that such agreement merges all existing claims and counterclaims, and is legally enforceable and final except in the event of fraud.

The negotiated settlement has the following outstanding advantages as enumerated in the Army Ordnance Report:

1. The settlement is arrived at as result of conference and by mutual agreement. It permits a sensible and businesslike compromise and adjustment of claims not susceptible of exact demonstration.

- "2. The settlement, being founded on contract, has the legal finality of any original contract and hence check by other governmental agencies on such matters entrusted to the judgment and the discretion of the contracting officer is not required.
- "3. Technical accounting and audits are reduced to the very minimum consistent with the protection of the Government's interests.
- "4. Accounting data and documentary evidence need not be submitted to other governmental agencies with resulting duplication of effort and disruptive uncertainty.
- "5. The negotiated settlement carries with it adequate provisions for securing immediate partial payments and these are available not only to the prime contractor but to subcontractors and remote subcontractors."

Under Secretary of War Patterson in his statement before the Murray Sub-Committee on November 8th, made it clear that termination was a group action, even though decentralized, and that contractors could not get together with the contracting officer and "make a deal." The contracting officer deals with the contractor, but his final decision is made in conjunction with his associates or superiors.

The various manuals and other sources of information should be studied, and procedures planned in detail and reduced to writing. The contractor should have a series of check-lists of things to be done before termination, when termination notice is received on individual contracts, and when wholesale termination comes. Forms should be prepared and on hand. For example, if inventory tags are to be used, they should be printed now, or it will be too late. Inventory instructions should be written. Ingenuity will suggest many things that can be done now to save precious time and protect the contractor's interests when the moment of termination arrives. The exact wording of telegrams or letters of notification to vendors should be worked out with the advice of attorneys. Instructions may be sent to subcontractors or vendors indicating the steps they should take in the event of termination. If purchase orders have no termination clauses, consideration should be given to the desirability of attempting to get vendors' signatures to Government approved forms of agreement for negotiated settlement if termination occurs.

Prime contractors should consult their contracting officers and subcontractors should consult their contractors as to the procedures that will be expected. Upon receipt of notice of termination, instructions should be obtained from contracting officer or otherwise as to what to do with work in process. Sometimes it should be sold for scrap or

otherwise; sometimes it should be completed. Material should not be hoarded in the vague hope that it may have some future use or value. In this, as in all things, the primary consideration should be to help the war effort. This phrase recurs so often in the official literature that it would seem due consideration should be given to any contractor who can show that every step of the way he has had a sincere desire to help the war effort.

The contractor is supposed to be compensated for "costs, expenditures, liabilities, commitments *and work* in respect to the uncompleted portion of the contract," including "such allowance for anticipated profit with respect to such uncompleted portion of the contract as is reasonable under the circumstances."

Inventories should be scrutinized to determine that quantities are not excessive for the needs of contracts, as contractors cannot expect the government to bail them out for unreasonable inventories. The contracting officer should be consulted and all official announcements carefully scrutinized for instructions covering disposal of inventories.

Upon receipt of notice of termination, the contractor should stop work and take an inventory; then determine what to do with work in process if he has not already found out, and, as soon as he gets proper clearance, put into immediate motion the machinery already prepared for disposal of those inventories that he does not want to retain.

He should list all open purchase orders and commitments, determine status of all contracts, and take any necessary action. He should transfer employees no longer needed on war work. He should send out notices to vendors and see that they stop work and take inventory, and tell them what to do about material on hand and commitments.

Immediate steps should be taken to segregate and protect all inventories, facilities, and other property belonging to the Government. These will include all items whose cost has been reimbursed or which enter into the claim. There should be complete and orderly records of all items by which to know their identity, location and cost.

A calculation should be made of the profit which probably would have been made if the contract had been carried to completion. The costs incurred up to the time of termination should be compared with the total contract price minus estimated cost of completion.

It will be important to demonstrate to the contracting officer the extent to which the work has been completed on the contract, the relative importance of the work completed, and the relative unimportance of the uncompleted work. The completed portion will usually include the engineering work, production scheduling and planning, technical study and supervision, elimination of difficulties and other services requiring skill and knowledge.

Claims should be prepared in such a way that it is easy to distinguish amounts clearly allowable from amounts which may be questionable. Provision is made for prompt payment by the Government of partial payments to the contractor which in the judgment of the contracting officer are clearly within the amounts due.

A filing system should be provided for all termination matters in which all documents, correspondence, working papers, etc., should be filed in an orderly manner.

Care should be taken to identify, record and support all charges for salaries, wages and other expenses incurred subsequent to termination, but for which reimbursement is expected. Included in this may be cost of taking inventories, handling government property, protection of inventories, negotiating with vendors, and the expenses of the actual settlement, including necessary legal and other professional services.

It stands to reason that the better the form in which claims are rendered, the better the records, the statistics and the basic accounting, the sooner contractors and contracting officers will come into agreement and free plants, capital, and minds.