Financial Inability and the Default Termination of Defense Supply Contracts: A Small Business Case Study

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Financial Inability and the Default Termination of Defense Supply Contracts: A Small Business Case Study

The allocation of a fair proportion of defense procurement to small business is a continuing problem of national economic policy. Perhaps the greatest single barrier for small-business contractors is the need for adequate financial resources. In this Article, Lieutenant Speidel examines the various forms of financial assistance available to small business with an eye to their effectiveness in the face of imminent default due to financial inability. He concludes that neither the Defense Contract Financing Regulations nor the Small Business Act, as presently implemented, affords adequate assistance to small businesses which encounter private financing problems after performance of their contracts has commenced. Lieutenant Speidel suggests that small businesses bidding on defense contracts should be able to establish their credit with the Small Business Administration regardless of the apparent availability of private financing, thereby averting the administrative delays involved in changing from private to public financing. He also suggests that the Government should apply broader concepts of excusability to excuse defaults traceable to wrongful denial of private credit.

Lt. Richard E. Speidel*

I. Introduction

The performance of Defense Department fixed-price supply contracts is a challenging task. Defense procurement is voluminous in
quantity and complex in nature. Performance of defense contracts frequently requires specialized property and know-how, continuing research and development, and a willingness to assume unique business risks which add uncertainty to pricing. All of these factors have contributed to an increasing concentration of the defense dollar in the hands of large contractors, and have precipitated a full-scale effort by Congress and the military departments to increase the number of prime contractors and subcontractors willing and able to satisfy the Government's defense needs. A principal part of this effort has been devoted to securing for small businesses an equi-

ever, they may provide for a redetermination of the contract price. Fixed-price supply contracts are awarded either through formal advertising or through negotiation. Armed Services Procurement Regulation (hereafter cited as "A.S.P.R." § 7-102, 2 Gov'T CON'T. REP. ¶ 32683 (1959).

2. Spending for national security is between 40 and 45 billion dollars a year, or approximately 10% of the gross national product. The largest part of the 25 billion dollars spent by the Department of Defense in fiscal year 1959 was used for research and development, and for the production of complex military weapons and equipment which had no commercial counterpart. See DEPARTMENT OF DEFENSE, PROCUREMENT PRESENTATION TO THE PROCUREMENT SUBCOMMITTEE OF THE SENATE COMMITTEE ON ARMED SERVICES 1–2 (1960). See also Weidenbaum, The Timing of the Economic Impact of Government Spending, 12 NAT'L TAX J. 79 (1959); and Novick & Springer, Economics of Defense Procurement and Small Business, 24 LAW & CONTEMP. PROB. 118 (1959).

3. The general trend toward business concentration is clearly reflected in defense procurement. In 1959, 73.8% of the total dollar volume of defense prime contracts over $10,000 was shared by 100 contractors, and 21% of the total dollar volume was awarded to only four contractors. During fiscal year 1959, contracts comprising only 16% of all contracts awarded by the Department of Defense were awarded to small business. See Wall Street Journal, Jan. 14, 1960, p. 15, col. 6. In 1953, the top 100 contractors were receiving about 63% of the defense dollar. See H.R. REP. No. 1252, 86th Cong., 2d Sess. 51 (1960). See also Rosebluth, The Trend in Concentration and its Implications for Small Business, 24 LAW & CONTEMP. PROB. 192 (1959).

The tendency of the procurement authorities to rely upon a relatively few, large suppliers has been severely criticized:

The military has exhibited a preference to deal with the few rather than the many; it has shown reluctance to break down a large order which can be filled only by a giant concern into a series of smaller orders which will invite independents to bid. Thus the military, with an eye solely to defense, gives impact to the trend toward concentration.


5. A "small business" is one which is independently owned and operated, and which is not dominant in its field of operation. Business dollar volume and the number of persons employed both are relevant to this definition. Where the number of employees is a criterion, the maximum number is varied "from industry to industry to the extent necessary to reflect different characteristics of such industries and to take proper account of other relevant factors." 72 Stat. 384, 15 U.S.C. § 632 (1958). Except for "special industry," the Armed Services Procurement Regulation places the maximum number at 500, unless the contractor "is certified as a small business by SBA [the Small Business Administration]." A.S.P.R. § 1–701.1(a)(1), 2 Gov'T CON'T. REP. ¶ 32131 (1960). The SBA's definition of "small business" for purposes of
table opportunity to compete for defense prime contracts and subcontracts.  

A prospective Government contractor, regardless of size, is responsible for obtaining adequate working capital to finance contract performance. The traditional sources of this short-term financing have been internal operations, retained earnings, commercial lending institutions, and factors. These sources, however, are not always adequate or available, and if the Government were to accept the bid of an otherwise capable contractor which is unable to obtain private financing, the Government's contractual position would be jeopardized. To resolve this dilemma, the Government has developed a program of financial assistance designed to facilitate full and timely contract performance.

Because the availability of private financing to small businesses is uncertain, varying with the condition of the money market and the credit position of the applicant, Government financial assistance to the small-business contractor is extremely important. This Article will examine the effectiveness of Government small-business financing with respect to the performance of Defense Department fixed-price supply contracts. In order to sharpen the focus of this examination, a recent decision by the Armed Services Board of Contract Appeals is used as a case study.

Government procurement may be found in 13 C.F.R. § 121.3-8 (Supp. 1960). For a critical discussion of size standards, see H.R. REP. No. 1252, supra note 3, at 41-44.

6. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect in so far as is possible, the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for property and services for the Government . . . be placed with small-business enterprises, to insure that a fair proportion of the total sales of government property be made to such enterprises, and to maintain and strengthen the overall economy of the Nation. 72 Stat. 384, 15 U.S.C. § 631 (1958). Accord, Armed Services Procurement Act, 10 U.S.C. § 2301 (1958). To effectuate this policy and to co-operate with the SBA, the Department of Defense sets aside certain procurements exclusively for small-business contractors, A.S.P.R. § 1-706, 2 Gov't Contr. Rep. ¶ 32147 (1960), and encourages prime contractors to subcontract to small businesses, A.S.P.R. § 7.104.14, 2 Gov't Contr. Rep. ¶ 32701 (1960). During fiscal years 1956 through 1959, small businesses were awarded 64,605 set-aside contracts valued at 3.446 billion dollars. H.R. REP. No. 1592, supra note 3, at 32. The SBA also has authority to make a conclusive certification of the competency of any small business as to business capacity and credit, A.S.P.R. § 1-705.6, 2 Gov't Contr. Rep. ¶ 32145 (1960), and to enter into prime contracts with the United States with the intent to subcontract to small businesses, 72 Stat. 384, 15 U.S.C. § 637(a) (1958).


8. The Armed Services Board of Contract Appeals represents the Secretaries of the Army, Navy, and Air Force in "hearing, considering and determining as fully and finally as might each of the Secretaries . . . appeals by contractors from de-
A. The Security Signals Case

In March of 1957, Security Signals Corporation submitted the low bid on an Army small-business "set-aside" contract for the manufacture of 221,000 urgently needed aluminum windshields for 155-mm shells. The contract price was approximately $70,000, and installment deliveries were required to be made between June of 1957 and July of 1958. A pre-award survey$ revealed that Security Signals had satisfactorily performed five previous Government contracts, and that three of those contracts had been financed by the same bank. Based upon these facts, the contracting officer determined that Security Signals possessed the physical ability, know-how, and integrity to perform the contract in question. The only remaining consideration was that of financial ability. Security Signals' financial statement revealed a cash position of about $30,000, an amount patently inadequate to support performance of the contract. The crucial question, therefore, was whether the bank which had financed three previous contracts was again willing to provide the necessary working capital.

In response to an inquiry from Security Signals, the bank made the following report to the contracting officer:

We have extended credit to this corporation for several years and they have shown their ability to meet their obligations in connection with previous contracts they have had. We are of the opinion that we may be able to take care of the needs of this corporation in connection with the above referred to contract although we cannot at this time make a definite commitment as we have not seen the contract.\[10\]

decisions on disputed questions by contracting officers . . . pursuant to the provisions of Armed Services contracts. . . . A.S.P.R. app. A, pt. 1, § 4, 2 Gov't Contr. Rep. ¶ 33741 (1959). Defense Department fixed-price supply contracts contain the following disputes clause:

Except as otherwise provided in this contract, any dispute concerning a question of fact arising under this contract which is not disposed of by agreement shall be decided by the contracting officer, who shall reduce his decision to writing and mail or otherwise furnish a copy thereof to the Contractor. The decision of the Contracting Officer shall be final and conclusive unless, within 30 days from the date of receipt of such copy, the Contractor mails or otherwise furnishes to the Contracting Officer a written appeal addressed to the Secretary. The decision of the Secretary or his duly authorized representative for the determination of such appeals shall be final and conclusive unless determined by a court of competent jurisdiction to have been fraudulent, or capricious, or arbitrary, or so grossly erroneous as necessarily to imply bad faith, or not supported by substantial evidence.

9. A pre-award survey is made to assist the contracting officer to determine the responsibility of a prospective contractor; it consists of an inspection of plants and facilities, and of interviews with the contractor's personnel. A.S.P.R. § 1-905.4, 2 Gov't Contr. Rep. ¶ 32173.80 (1960).

On the basis of this apparently harmonious relationship with the bank, Security Signals was determined responsible with regard to credit and was awarded the contract.

It is significant that while Security Signals had submitted a formal loan application prior to award, no firm commitment had been obtained from the bank. Further, Security Signals did not request financial assistance from the Government.

After award of the contract, the bank refused the loan application on the apparently justified belief that—contrary to the bank's recommendation—Security Signals was using all available funds for capital expansion. At this point, Security Signals had no arrangements for working capital and was unable to obtain financing from private sources. Pressed for payment by suppliers and hampered by deteriorating credit, Security Signals was soon 50,000 units in default. Consequently, Security Signals requested the Government to cancel the contract. The contracting officer, however, elected to assist Security Signals in attempting to obtain from Government sources the financing required to complete performance.

A loan from the Small Business Administration was impractical because of an estimated six- to eight-week delay in processing the application. Security Signals' poor financial position deterred the contracting officer from authorizing progress payments or advance payments on the contract in question. Finally, it proved impossible to arrange an acceleration of payments under other Government contracts being performed by Security Signals. With all possible avenues of financial assistance foreclosed, Security Signals repudiated the contract.

In view of Security Signals' admitted financial inability, the contracting officer advised Security Signals that if action were not taken within 10 days to assure completion of the contract within a reason-

11. The contractor's evidence indicated that the capital improvements were absolutely necessary, were financed with the personal funds of its president, and were made in December of 1956. The bank, however, argued that Security Signals had used all available funds for this expansion, and that its cash position as of June 30, 1957, was very poor. Without resolving this factual conflict, the ASBCA determined that the failure of Security Signals to obtain a loan was within its control and due to its own fault or negligence.

12. Security Signals' cash position deteriorated from $31,000 on March 15, 1957, to less than $500 in August of 1957. The Government had estimated that production in accordance with the contract would cost about $10,000 a week.

13. Security Signals' letter to the contracting officer stated in part:

It will be impossible for us to continue producing the Windshield on the above referenced contract as there is no money available and it will be necessary for us to sell our die casting machines in order to have working capital to produce on two Chemical Corps contracts. We have been to several other banks and cannot borrow the money. There is nothing left for us to do but sacrifice some of our capital equipment in order to continue in business.

able time, the contract would be terminated for default. When no response was received within 10 days, the Government effected by written notice a default termination, repurchased the undelivered units from another source, and charged the excess costs of repurchase to Security Signals’ account. Security Signals took timely appeal to the Armed Services Board of Contract Appeals (ASBCA), protesting the default termination and assessment of excess costs.

On appeal, Security Signals argued that the performance failure and financial inability were due to causes beyond its control and without its fault or negligence, and that the default termination and subsequent assessment of excess costs were therefore improper. The ASBCA found that Security Signals had no definite or reasonable financing arrangement upon which it could rely when its bid was submitted, and held that financial inability extant at the time of bidding does not excuse a failure to perform. The ASBCA further concluded that the factors which caused the bank to deny the loan after bid and award were not beyond the control of Security Signals and not without its fault or negligence. Accordingly, the appeal was denied.

B. The Problems Raised by Security Signals

The Security Signals case illustrates four stages in the performance of defense contracts which are of critical importance to small businesses. The first is the determination of financial responsibility prior to award. What are the limitations upon the contracting officer’s discretion in obtaining responsible contractors? The second is the Government’s decision to provide financial assistance. What are the nature and limitations of this assistance, particularly when the need for financing first arises during actual performance? The third is the Government’s contractual right to terminate a contract for a default caused by financial inability. At what point may the Government terminate the contract and repurchase the supplies from another source? The fourth is the determination of “excusability” before the ASBCA. Under what circumstances will the Government contractually assume the risk of a contractor’s failure to perform because of financial inability?

II. FINANCIAL ABILITY AND THE AWARD OF GOVERNMENT CONTRACTS

To be eligible for the award of Government supply contracts, a prospective contractor, regardless of size, must be “responsible.”

This requirement protects the Government and envisions a contractor which, at the time of contract award, possesses both the business capacity and credit necessary to deliver the supplies required within the time specified.\footnote{Determinations of responsibility are made by the contracting officer. Necessarily, he has a great amount of discretion in deciding whether a particular business concern can satisfy the needs of the Government. A prospective contractor's experience, its previous performance record, the complexity of the procurement—all will influence the thoroughness of the contracting officer's investigation.\footnote{Time limitations between the opening of bids and the date of award (1960), or by negotiation, A.S.P.R. § 3–102(iv), 2 Gov't Cont. Rep. ¶ 32279 (1960).}

Determinations of responsibility are made by the contracting officer.\footnote{A determination of responsibility is solely for the benefit of the Government. See 10 U.S.C. § 2305(c) (1958) (award by formal advertising to the responsible bidder whose bid conforms to the invitation and will be the most advantageous to the United States, price and other factors considered). See also Trand Plastics Co., ASBCA Dec. No. 3708, 57-1 BCA 3297 (1957). A contractor must be responsible at the time of contract award. 39 Decs. Comp. Gen. 62 (1959). The minimum standards of responsibility are established in A.S.P.R. § 1–903, 2 Gov't Cont. Rep. ¶ 32171 (1960). The contractor must be a manufacturer of, or a regular dealer in, the supplies to be furnished. 49 Stat. 2036 (1936), 41 U.S.C. § 35(a) (1958). In addition, the contractor must have adequate financial resources, the ability to comply with established delivery schedules, and a satisfactory record of prior performance and business integrity.

When financial responsibility is at issue, the Defense Contract Financing Regulations, A.S.P.R. app. E, §§ 000–528, 2 Gov't Cont. Rep. ¶¶ 35751–35758.33 (1959), are to be considered in conjunction with the basic responsibility regulations, A.S.P.R. § 1–903, 2 Gov't Cont. Rep. ¶ 32171 (1960). On the assumption that financial difficulties disrupt production schedules, waste manpower and materials, and may cause monetary loss to the Government, the Defense Contract Financing Regulations provide that “contracts should be entered into only with those potential contractors who . . . have the financial capacity or credit . . . technical skill, management competence, and plant capacity and facilities . . . reasonably to assure their ability to perform their contracts in accordance with their terms.” A.S.P.R. app. E, § 211, 2 Gov't Cont. Rep. ¶ 35753.55 (1959).}


may force the contracting officer to consider superficial evidence which presents an unrealistic financial picture. Even with ample time the contracting officer’s task is often difficult, for a sound financial evaluation requires thorough knowledge of the prospective contractor’s entire business operation. Thus the contracting officer must ask—and answer—any number of complex questions: To what extent have other business commitments overloaded capacity and overextended financial resources and credit? How does estimated work volume compare with overhead? Are other work orders and commitments properly scheduled in relation to financial needs? Does the potential contractor have sufficient experience to submit realistic cost estimates and to anticipate future cost problems?18

The task of the contracting officer is further complicated by subcontracts.19 There is no direct contractual relationship or privity between the subcontractor and the Government;20 the decision to subcontract and the selection of subcontractors have traditionally been the business responsibility of the prime contractor. However, in all prime contracts the Government is interested in whether a proposed subcontractor has finances adequate to ensure satisfactory performance.21 Where negotiated contracts are involved, the Government is particularly interested in the effect of subcontracting on the prime contract price. Pursuant to these governmental interests, recent regulation changes have increased the Government’s control over the subcontracting procedures of prime contractors.22 In more complex procurements of a substantial dollar volume, the subcontractor must be selected after adequate competition23 and after

19. A subcontract is defined as “any contract . . . other than a prime contract, entered into by a prime or a subcontractor, calling for supplies or services required for the performance of any one or more prime contracts.” A.S.P.R. § 8-101.23, 2 Gov’t Cont. Rep. ¶ 32888 (1960). This broad definition includes materialmen and suppliers as well as parties performing work in accordance with the prime contract specifications. See 18 Decs. Comp. Gen. 683 (1939).
small businesses have been given an equitable opportunity to compete. One conclusion to be drawn from the recent regulatory trend is that the Government's increased control of the subcontracting process has eroded an area of business judgment previously exercised by the prime contractor. But of more significance to the present discussion, the Government's control of subcontracting has introduced another complex element into the contracting officer's determination of financial responsibility.

In order to satisfy the current regulatory requirement of "credit" responsibility, the prospective contractor must have, at the time of award, either adequate financial resources or the ability to obtain them as required during contract performance. The best evidence of ability to obtain adequate financing is "a commitment or explicit arrangement in existence at the time of contract award." Security Signals, of course, did not at any time have on hand the cash necessary to finance its contract. Evidence of Security Signals' ability to obtain the requisite working capital consisted of a continuing, harmonious relationship with a bank which had adequately financed previous contracts. Yet Security Signals had no firm financial commitment from that bank, a fact of which the contracting officer was aware. Did the contracting officer abuse his discretion by awarding the contract to Security Signals without the best evidence of financial responsibility?

The contracting officer is authorized to determine responsibility because his day-to-day relations with the contractor place him in the best position to assess business capacity and credit. Consequently, if a disappointed bidder protests an unfavorable determination, the contracting officer's decision will not be overturned unless there is
convincing evidence of bad faith, or unless there was no reasonable basis for the determination.29

A determination of responsibility may reasonably be based upon the contractor's apparent ability to perform the contract; an examination of all available evidence is not necessarily required.30 On the assumption that a prospective contractor has no inherent right to a Government contract, the courts have refused to review a negative determination unless the claimant alleges fraud, malice, coercion, or conspiracy on the part of contracting officials.31 In passing, it may be worthy of note that although a contractor would ordinarily have no reason to object to a positive determination of its own financial responsibility, a contract award could conceivably be avoided by a timely protest to the General Accounting Office if the determination were grossly erroneous or were made in bad faith.32

When a small business is determined to be "not responsible" as to capacity and credit, the contracting officer must refer the case to the Small Business Administration for review. Under section 8(b)(7) of the Small Business Act, the Small Business Administration has the authority both to determine that the prospective contractor is responsible and to issue a certificate of competency as to capacity and credit which is binding upon the contracting officer.33 A certificate


30. Comp. Gen. Ms. B-142055, April 12, 1960 (prior unsatisfactory performance provides apparent substantial basis for determination of nonresponsibility); 37 Decs. Comp. Gen. 798 (1958) (determination of nonresponsibility upheld even though based upon poor prior performance at only one Army post and exercise of greater diligence would have produced evidence of satisfactory performance elsewhere).


32. There is no direct authority for this proposition. However, it has been established that the contracting officer may not, in good faith, award a contract if there is a gross error apparent on the face of the bid. Comp. Gen. Ms. B-139435, May 14, 1959 (unpublished); Comp. Gen. Ms. B-141568, Jan. 11, 1960 (unpublished). See Monroe Mfg. v. United States, 143 F. Supp. 449 (E.D. Mich. 1956) (contracting officer on notice of error where average of three low bids is six times higher than lowest bid). But cf. 39 Decs. Comp. Gen. 405 (1959) (no notice of error merely because low bid out of line with current prices in highly competitive industry). Analogizing these precedents to the problem of financial responsibility, it is arguable that a contracting officer may not, in good faith, award a contract where his examination reveals a gross deficiency in financial resources.

33. It shall also be the duty of the Administration and it is empowered, whenever it determines such action is necessary . . . to certify to Government procurement officers . . . with respect to the competency, as to capacity and credit, of any small-business concern or group of such concerns to perform a specific Government contract. . . . [T]he officers of the Government having procure-
of competency is conclusive as to all matters of business capacity and financing, although the contracting officer retains his discretion in the area of business integrity.\footnote{34}

In considering the propriety of the contracting officer's determination of financial responsibility in \textit{Security Signals}, two things should be noted. First, a certificate of competency was not involved, since \textit{Security Signals} was found to be responsible. Second, neither \textit{Security Signals} nor the competing bidders protested the determination. Thus there was general agreement as to the existence of an apparent ability to obtain adequate financing, even though there was no firm commitment from the bank at the time of contract award. There being no question as to the contracting officer's good faith in making the determination, the only real issue is whether he had a reasonable basis for his decision.\footnote{35} Certainly an existing, harmonious relationship with a bank which had financed several previous contracts may reasonably be equated to an apparent ability to obtain financing, even though not constituting the best evidence of that ability. The proper conclusion is, therefore, that the contracting officer did not abuse his discretion in awarding the contract to \textit{Security Signals}.

\begin{itemize}
  \item The chief price analyst, a member of the contracting officer's team, admitted that the Government knew that a commitment to provide financing did not exist. He testified, however, that the letter indicating a harmonious relationship between \textit{Security Signals} and the bank was apparently common banking procedure and that all letters were "pretty well the same." \textit{Security Signals}, Inc., ASBCA Dec. No. 4634, 58-2 BCA 5857, 5859 (1958). He added, "I would like to say this letter established the fact that the Security Signal Corporation was in a relationship with a bank consistent with what had existed in the past." \textit{Ibid.}
\end{itemize}
However, abuse of discretion and realistic contract administration are two different things. The cold fact is that in the Security Signals case, the contracting officer permitted an inadequately financed small business to undertake an important Government contract.\textsuperscript{36} The results of that unfortunate decision were delay and additional cost to the Government, and near-bankruptcy to the contractor. The "apparent ability" to obtain adequate financing afforded little consolation to Security Signals when its loan request was refused by the bank—and even less when the issue of excusability was argued before the ASBCA. If the participation of small businesses in defense procurement is to be effectively implemented, no small business should be awarded a contract until firm, adequate, financial arrangements have been obtained. Only at this level of administrative responsibility are the interests of both the Government and the small-business contractor adequately protected.

III. Government Financial Assistance to Small Business: Its Purpose and Limitations

The Government administers a program of financial assistance for the benefit of otherwise-competent contractors which cannot obtain adequate working capital from private sources. This assistance is theoretically available either to supplement the contractor's financial resources at the time of award or to meet a need which first arises during actual performance of the contract.\textsuperscript{37} However, the program of Government financial assistance has definite limitations in the latter situation. For this reason, it is necessary to examine the nature and limitations of Government financial assistance, with the immediate purpose of discovering why it was ineffective in the Security Signals case.

\textsuperscript{36} The risk of a later performance failure is extremely high when the contracting officer awards a contract to a concern in poor financial condition. See R. P. Bennett Co., ASBCA Dec. No. 3738, 57-1 BCA 3812 (1957) (inadequate arrangements at time of award); Newark Weaving Mills, ASBCA Dec. No. 3026, 56-2 BCA 2096 (1956) (insufficient credit at time of award); Selector Indus., ASBCA Dec. No. 1635, 6 Contract Cases Federal (hereafter cited as "CCF") § 61769 (1955) (too many commitments for financial resources); Paint & Pack Corp., ASBCA Dec. No. 1341 (1953) (inadequate resources, unrealistic pricing at award); Bernal Narrow Fabrics, ASBCA Dec. No. 1604 (1953) (limited cash, no credit); Mifflinburg Body Works, ASBCA Dec. No. 723, 5 CCF § 61276 (1951) (shaky finances at award).

\textsuperscript{37} The need for contract financing will not be treated as a handicap in awarding contracts to qualified contractors which are deemed competent and capable of satisfactory performance. A.S.P.R. app. E, § 210, 2 Gov't Contr. Rep. § 35753.50 (1959). If the need for financing first arises after award, the fact that the contractor previously disclaimed any need will not disqualify it from proper financing. A.S.P.R. app. E, § 210.1, 2 Gov't Contr. Rep. § 35753.50 (1959).
A. Assignment of Contract Proceeds

In general, a contractor may not assign claims against the United States or interests in Government contracts. However, an exception exists where payments in excess of $1,000—due or to become due under a Government contract—are assigned by the contractor to a bank, trust company, or other financial institution (including a federal lending agency) as security for a working-capital loan. This exception enables a contractor to obtain financing on the security of successful contract performance, thereby obviating the necessity of a mortgage on its capital assets or inventory.

The assignee's interest in a Government contract is not ordinarily subject to setoff by the Government of claims against the assignor, and this is true whether or not the Government's claims arose out of the same transaction. If the assignor defaults in performance, however, the Government's contractual right to any excess costs of repurchase takes precedence over claims of the assignee.


39. Both 31 U.S.C. § 203 (1958) and 41 U.S.C. § 15 (1958), provide that unless expressly authorized by the contract, an assignment shall not be made to more than one party and shall not be subject to further assignment, except that any such assignment may be made to one party as agent or trustee for two or more parties participating in such financing. For a questionable interpretation of this provision, see Chelsea Factors v. United States, 181 F. Supp. 685 (Ct. Cl. 1960). The statutes also require the assignee to file a written notice of the assignment with the contracting officer, with bond sureties, and with the contract disbursing officer.

40. Prior to 1951, the Government was authorized to set off claims for the contractor's failure to perform "collateral" promises. See 30 DECS. COMP. GEN. 98 (1950) (withholding payroll deductions). Since the 1951 amendment prohibiting the setoff of independent or dependent claims, the assignee is entitled to the full amount owed by the Government to the contractor for proper performance. See 37 DECS. COMP. GEN. 318 (1957). The Government cannot regain possession of monies paid to the assignee unless fraud can be proved, American Fidelity Co. v. National City Bank of Evansville, 266 F.2d 910 (D.C. Cir. 1959), or the payments were improperly made under the agreement between the contractor and the Government, Newark Ins. Co. v. United States, 181 F. Supp. 246 (Ct. Cl. 1960).

41. Southside Bank & Trust Co. v. United States, 221 F.2d 813 (7th Cir. 1955); 35 DECS. COMP. GEN. 149 (1955); 4 CORBIN, CONTRACTS 895-97 (1951). An assignee has no more right to contract proceeds than the assignor had. See Newark Ins. Co. v. United States, 181 F. Supp. 246 (Ct. Cl. 1960). If the assignor has failed to perform the contract and is contractually obligated to pay the excess costs of repurchase, the assignee's claim is subject to this limitation. Cf. United States v. Munsey Trust Co., 332 U.S. 234 (1947); Prairie State Bank v. United States, 184 U.S. 227 (1899). If the Government holds contract proceeds owed to a defaulting contractor as a stakeholder, the Court of Claims has given payment-bond sureties preference in order of payment over the assignee. National Surety Corp. v. United States, 133 F. Supp. 331 (Ct. Cl. 1955). Contra, American Surety Co. v. Hinds, 260 F.2d 368 (10th Cir. 1958). But see American Fidelity Co. v. National City
Financing by means of an assignment of contract proceeds is a device which is potentially available to all Government contractors. Its effectiveness, however, depends upon successful contract performance. If the contractor falls behind in deliveries or fails to make substantial progress, the assignee will receive fewer payments of contract proceeds from the Government and will correspondingly reduce its working-capital payments to the contractor. Therefore, although an assignment of receivables may assist the small-business contractor in obtaining definite financial commitments at the time of contract award, it offers little comfort when unexpected difficulties are encountered during performance of the contract.4

B. Loans Under the Small Business Act

In order to satisfy the short- and intermediate-term borrowing needs of small business, Congress has established a 575-million-dollar revolving fund for use by the Small Business Administration (SBA) in providing loans to small businesses.43 A qualified applicant may obtain up to $350,000 at no more than 5% per cent interest per annum, for periods up to 10 years. A primary purpose of this assistance is to provide working capital for both commercial and defense production. If a small business cannot obtain adequate financing from private sources at reasonable rates, the SBA may attempt to stimulate private financing by lending its credit to the small business, through either an immediate or deferred participation.44 If this approach is not successful, the SBA may then make a direct loan from appropriated funds.45


44. The SBA's policy is to attempt to induce the lending institution to make the loan on the understanding that the SBA will participate at a later time, if necessary. This policy is dictated by law: "No immediate participation may be purchased unless it is shown that a deferred participation is not available; and no loan may be made unless it is shown that a participation is not available." 72 Stat. 387, 15 U.S.C. § 636(a)(2) (1958).

45. The total number of loans approved under the SBA small business loan program in the period between the inception of the act through June 30, 1959 . . . is 14,609 representing $690,053,372. The SBA's share of these loans is $582,888,654. Of these loans approved, a total amount of $582,394,919 has been disbursed on 12,914 loans. The SBA's share of the funds disbursed was $490,583,060 [the remainder being supplied by participating institutions].
Both prime contractors and subcontractors may apply for direct loans under the Small Business Act. Because these loans are administered by an agency other than the contracting agency, difficulties encountered by a contractor in performing a particular defense contract do not affect the availability of a direct loan from the SBA. However, a routine two- to six-month delay in the SBA's processing of loan applications, coupled with a rejection rate of approximately 45 per cent, make this form of financial assistance more effective if obtained prior to award of the contract rather than during its performance.

C. The Defense Contract Financing Regulations

The Defense Contract Financing Regulations are applicable to all types of defense contracts for work, supplies, and services. These regulations authorize guaranteed loans, progress payments, and advance payments necessary to finance both performance and termination of the contract; partial payments made upon delivery of a portion of the units called for under the contract are not considered to be "financing," within the meaning of the regulations.

The Government prefers that the contractor obtain private financing, provided that such financing is available at reasonable rates. If private financing is not feasible, however, direct financial assistance will be considered by the Government in the following order of preference: customary progress payments, guaranteed loans, unusual progress payments, and advance payments. It is important to realize that the primary purpose of these methods of financial assistance is to facilitate timely contract performance. Consequently, the contractor's need for financing is carefully weighed against the probability of successful performance within the time specified by the contract. The availability of appropriated funds is, of course, a limiting factor in every case.

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has been a steady increase in both the number of loans approved and the total amount of funds disbursed in each fiscal year since the lending program began, the largest increase being in fiscal year 1959, immediately subsequent to the time the SBA was made a permanent agency.


47. The SBA often takes from two to six months to process loan applications. Approximately 40-45% of all applications are ultimately rejected. See H.R. REP. No. 1252, note 45 supra, at 38-39, 45.

48. The new Defense Contract Financing Regulations were issued on May 25, 1959, and supersede the joint finance regulations of December 17, 1956, issued as AR 715-6, NAVEXOS P-1006 (NPD 31-001) and AFR 173-133. The new regulations are contained in Appendix E of the Armed Services Procurement Regulation.


50. Ibid.

If a commercial lending institution is unwilling to furnish working capital on the security of a contractor's credit or assignment of receivables, the Government may be willing (for a fee) to guarantee the loan under section 301(a) of the Defense Production Act of 1950. If a commercial bank which requires a guarantee must apply through the local federal reserve bank to the interested guaranteeing agency. If the loan is for the purpose of providing working capital for a contractor holding an essential defense contract — and no other source of financing is available — the guaranteeing agency is authorized to issue a certificate of eligibility. Upon receipt of such a certificate, the federal reserve bank executes a guarantee contract with the lending bank, the latter disbursing funds to the contractor and administering the loan.

Both the maximum amount of guaranteed credit and the maturity date of the loan are set in reasonable conformance with the contractor's requirements for the defense contract (or contracts) being performed. Under the guarantee contract, the guaranteeing agency is obligated — upon demand of the lending bank — to purchase a stated percentage of the loan and to share losses in the amount of the guaranteed percentage, which is normally 90 per cent of the borrower's investment in defense production contracts. The amount of this investment is determined by an asset formula embracing all items for which the borrower would be entitled to payment upon performance or termination of its contracts. In exceptional cases in


53. Authorized guaranteeing agencies are the departments of the Army, Navy, Air Force, Agriculture, Commerce, and Interior, as well as the General Services Administration and the Atomic Energy Commission. A.S.P.R. app. E, § 306, 2 Gov't Cont. Rep. ¶ 35754.30 (1959). The National Air and Space Agency has recently been added to this list. Exec. Order No. 10819, 24 Fed. Reg. 3779 (1959). If more than one agency is interested in financing a group of prime contracts or subcontracts involving several agencies, the agency with the preponderance of interest — on the basis of dollar amount of the prospective borrower's unfilled and unpaid balance — is the responsible agency.


56. The asset formula does not include amounts to become due upon future per-
which the operations of a particular contractor are essential to the national defense, the guaranteed percentage may be increased to 100 per cent of the borrower's investment in defense contracts.\textsuperscript{57} The guaranteeing agency is secured by an assignment of receivables from the contractor and, where necessary, by a mortgage of fixed assets.\textsuperscript{58}

Special privileges are accorded to small businesses under the guaranteed loan program. Small businesses desirous of guaranteed loans, whether applying as prime contractors or subcontractors, need not show the unavailability of private financing if they are otherwise qualified.\textsuperscript{59} Small-business subcontractors may deal directly with the lending bank rather than through the prime contractor, although a loan is not available until the subcontract has been awarded.\textsuperscript{60}

(2) Progress payments based on costs

No separate consideration is required for the inclusion of a progress-payment clause in a fixed-price supply contract.\textsuperscript{61} If no provision for progress payments was made in the original contract, however, the contractor must give adequate, new consideration in order to obtain progress payments from the Government.\textsuperscript{62} Progress payments are made to the contractor as the work progresses, and generally are based either on costs incurred or on a specified percentage or stage of completion.\textsuperscript{63} However, the Defense Contract
Financing Regulations apply only to progress payments which are based upon costs.

The regulations provide for two types of cost-based progress payments: "customary" payments and "unusual" payments. The Government makes "customary" progress payments as a matter of course if (1) the contract calls for delivery six months or more after contract award, and (2) the contractor's working capital will be materially impaired by high predelivery expenses. Ordinarily, "customary" progress payments may not exceed 70 per cent of total costs incurred or 85 per cent of direct labor and material costs. If "customary" progress payments prove inadequate, the contractor may obtain payments in excess of the foregoing percentages— "unusual" progress payments—by demonstrating to the head of the procuring agency an "actual need therefor, with due regard to the [Government's] preference for private financing, including guaranteed loans." The exact percentage of costs allowed in a particular application for "unusual" progress payments will be limited by actual need. Whether "customary" or "unusual" payments are involved, the aggregate amount of the progress payments made may never exceed 70 per cent of the total contract price.

Although progress payments are essentially the equivalent of self-liquidating loans (to be repaid through delivery of the units specified in the contract), no interest is charged on them. The Government recoups any progress payments made to a given contractor by deducting a corresponding amount from the contract price of delivered units. This liquidation scheme does not require that the Government recover the entire amount disbursed as progress payments before more money may be paid to the contractor; rather, the Government recovers its progress-payment disbursements piecemeal, by deducting from the contract price due at delivery of each unit a given proportion of that price. In fact, the Government's deduction for unliquidated progress payments cannot exceed a certain percentage of the gross amount invoiced—70 per cent, in the case of progress payments computed in terms of total cost incurred. As security for

65. Ibid.
67. Ibid.
unliquidated payments, the Government takes “title” to all materials, inventory, work in progress, tools, and data which are acquired by the contractor for performance of the contract in question.\textsuperscript{70}

The Defense Contract Financing Regulations confer definite benefits upon small-business prime contractors which indicate a need for progress payments at the time of bidding or prior to award. If it appears that small businesses will bid for a contract, the contracting officer may provide for progress payments in his invitation for bids, even though the contract is one for which progress payments would normally be unavailable.\textsuperscript{71} Further, if it is determined that only small-business bidders will need progress payments, the contracting officer has authority under the Armed Services Procurement Act\textsuperscript{72} to restrict progress payments to those bidders alone.\textsuperscript{73} Finally, a small-business prime contractor is entitled to progress payments computed at 75 per cent rather than 70 per cent of total costs incurred, or at 90 per cent rather than 85 per cent of direct labor and material costs.\textsuperscript{74}

The plight of the small-business subcontractor has also been ameliorated by the Defense Contract Financing Regulations. The regulations now require prime contractors which are receiving progress payments to apply for and distribute progress payments to small-business subcontractors;\textsuperscript{75} prime contractors still have an option with regard to other subcontractors, however. Unlike the procedure for guaranteed loans,\textsuperscript{76} a subcontractor must channel its


\textsuperscript{74} As amended and codified in 10 U.S.C. § 2307(a)(2) (1958).


\textsuperscript{76} See note 60 supra and accompanying text.
application for progress payments through the prime contractor. This is accomplished simply by inserting a provision for progress payments in the subcontract.

(3) **Advance payments**

Advance payments are made by the Government to a contractor to enable it to complete contract performance.\(^77\) Advance payments may be made in conjunction with progress payments, but because advance payments are made without regard to work progress or costs incurred, the Government is more reluctant to authorize advance payments. Accordingly, in order to obtain advance payments, the typical contractor must show an actual need for financing which cannot be satisfied either from commercial sources or from other governmental sources.\(^78\)

When advance payments are received, the contractor must deposit them in a special bank account, and withdrawals are closely supervised by the Government to ensure that their use is restricted to actual need. The Government’s interest is further protected by a lien on the supplies contracted for, on the credit balance in the special account, and on property acquired for performance of the contract.\(^79\)

In addition, an advance-payment bond may be required.\(^80\)

As with progress payments, advance payments are liquidated by application against the contract price of delivered units or the cost of completed work. Unlike the treatment of progress payments, however, interest is charged on unliquidated advance payments at the rate of five per cent per annum.\(^81\)

Advance payments are designed to facilitate contract performance in difficult situations. One type of situation in which advance payments may be appropriate is where the contractor must perform a Government contract which is not fixed in price. Thus if the contractor must perform research and development, manage Government facilities, or acquire facilities under a cost-reimbursable contract, private financing is difficult to obtain and progress payments may be unavailable. Another such situation is posed by the essential contractor that has become financially overextended. Finally, there is the exceptional situation in which advance payments are more beneficial to the Government than any other method.

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80. Ibid.

of financing. The Government's authority to make advance payments in these and similar situations is spelled out in some detail in the Defense Contract Financing Regulations.\(^82\)

As pointed out previously, the primary purpose of advance payments is to enable the contractor to complete performance of its contract. Because successful performance may depend in part upon the actions of subcontractors, the Government has authority to make advance payments to prime contractors for advances to subcontractors.\(^82\) However, prime contractors must meet such exacting standards to obtain reimbursement for advances under the regulations that they are often reluctant to adopt this method of financing subcontractors.

**D. The Limitations of Government Financial Assistance**

In considering the limitations of Government financial assistance to small businesses, two important distinctions must be made. The first involves a difference in purpose between the assistance administered by the SBA and that provided by the military departments. The second relates to whether the contractor's financial need arises before or after contract award.

The primary purpose of the military departments in administering defense-contract financing is to obtain the timely delivery of good-quality supplies at the least possible cost to the Government. Small-business financial assistance which does not secure such performance is imprudent and may be beyond the scope of Defense Department financing. However, refusal of financial assistance by the Defense Department need not foreclose SBA assistance. The SBA administers a long-range program of economic assistance to small business in order to stimulate and expand the economy. Given the present emphasis on production for the national defense, it is proper that the SBA strive to provide maximum financial assistance to qualified concerns in the performance of defense contracts.

The second distinction turns upon whether the contractor's need for Government financing is indicated prior to award, or becomes apparent only during actual performance. Security Signals was 50,000 units in default and had practically no working capital when its need for Government financing was first revealed to the contracting officer. Unfortunately, none of the three forms of assistance provided by the Defense Contract Financing Regulations could be made available at that stage of performance.

If application had been made for a guaranteed loan, Security Signals might have qualified as an essential defense contractor under the Defense Production Act.\(^84\) However, this avenue would

\(^{84}\) See notes 54, 56 and 57 supra.
not be open to the many small-business contractors capable of supplying only standard, "off the shelf" items. Further, the time involved in processing a guaranteed loan application makes it impossible for an applicant to obtain immediate assistance.\textsuperscript{85} And even with a guarantee, it is unlikely that any private bank would be willing to advance funds to a small business already in default.

Under the facts of the Security Signals case, progress payments were also unavailable. The contract provided that the time between date of award and first delivery was to be only three months. Further there had been no indication that unusually high pre-delivery expenses would be incurred—despite the fact that by the time Government financing had become imperative, Security Signals' working capital and credit had deteriorated to a point where progress payments were deemed imprudent.\textsuperscript{86} Advance payments were denied for similar reasons.\textsuperscript{87}

In summary, except for extraordinary relief for essential defense contractors,\textsuperscript{88} the purpose of defense-contract financing often precludes effective assistance to businesses in financial distress, for the risk of monetary loss frequently exceeds the reasonable expectation of timely performance. The limitations upon defense-contract financing for small businesses become most apparent where the need for financing first develops during performance, rather than where pre-award arrangements for Government financing later

\textsuperscript{85} The average time required to process a guaranteed loan is 30 days. Processing of the loan application requires that it go through the private bank, the federal reserve bank, the guaranteeing agency, and then back again to the private bank. See Bachman, \textit{Defense Department Contract Financing}, 25 Geo. Wash. L. Rev. 228, 229 (1957).

\textsuperscript{86} If progress payments are arranged at the time of award, the contracting officer has authority to reduce or suspend the payments if contract performance is subsequently endangered by the contractor's poor financial condition and if the risk of monetary loss is high. See A.S.P.R. app. E, § 510.1(c), 2 Gov'T Contr. Rev. ¶ 35756.30 (1959); A.S.P.R. app. E, § 524.2 (1959). To avoid this action, the contractor must show that the supplies will be delivered on time and that complete liquidation of progress payments will occur, since the Government's assurance of repayment depends upon satisfactory performance. \textit{But cf.} United States v. Lennox Metal Mfg., 225 F.2d 302 (2d Cir. 1955) (contracting officer's administration of progress payments cannot be arbitrary, capricious, or unfair).


\textsuperscript{88} The President may authorize any department or agency of the Government which exercises functions in connection with the national defense, acting in accordance with regulations prescribed by the President for the protection of the Government, to enter into contracts or into amendments or modifications of contracts . . . and to make advance payments thereon, without regard to other provisions of law relating to the making, performance, amendment, or modification of contracts, whenever he deems that such action would facilitate national defense.

prove insufficient. It is much easier to increase the guaranteed percentage of a loan or to make unusual progress payments to a contractor which has been supervised since the date of award than it is to arrange new financial commitments as difficulties arise.

Therefore, it would seem that in situations in which the military departments are unable prudently to provide financial assistance, the Government's residual obligation to small business ought to be assumed by the SBA. If this agency is unable to act promptly, a serious gap exists in the Government's over-all program of financial assistance to small businesses. Yet in the Security Signals case the method of assistance especially designed for small businesses—a loan under the Small Business Act—was ineffective because of the length of time required by the SBA to process the loan application. 69

In view of the Security Signals case, it is permissible to conclude that prospective contractors which obtain Government financial assistance prior to award may be in a better position than those which first request Government financing during performance—an incongruous result, since the Government would prefer that contractors obtain financing from private sources. A second conclusion to be drawn from Security Signals is that the SBA may be—or at any rate ought to be—more willing to finance a particular small-business contractor than are the military departments. Of course the SBA was not created for the express purpose of "bailing out" concerns in poor financial condition, but if a small-business defense contractor's sole obstacle to performance is the lack of working capital, the broader objectives of the SBA support a favorable consideration of the contractor's application. 90 Yet the fact remains that in the Security Signals case, at least, a decision on the availability of financial assistance could not be obtained from the SBA in time to avert a default termination of the contract in question.

The obvious remedy for a contractor faced with this problem is to obtain a small-business participation or direct loan from the SBA prior to the contract award. However, if the contractor has a line of commercial credit 91 or other assurance of private financing, the

89. See H. R. Rep. No. 1252, supra note 45, at 45.
90. An SBA loan must be of "such sound value or so secured as reasonably to assure repayment." 72 Stat. 694, 15 U.S.C. § 636(a) (1958). SBA statistics reveal that the three primary reasons for rejecting loan applications are: (1) lack of reasonable assurance of ability to repay the loan and other obligations from earnings, (2) an unsatisfactory proportion of debts to net worth before and after the loan, and (3) collateral (along with other credit factors) not deemed sufficient to protect the Government's interest. See H. R. Rep. No. 1252, supra note 45, at 39. Only 5.3% of the total rejections from 1953 until June 30, 1959, were because the applicant would have had inadequate working capital after the loan. Since Security Signals' primary impediment was the lack of working capital, and since Security Signals was performing other Government contracts without difficulty, the reasons for rejecting a loan application were minimal in the Security Signals case.
91. Commercial lines of credit are established 4 to support the cash cycle dictated
SBA's services are not available. This difficulty could be alleviated if prospective defense contractors were permitted to establish credit with the SBA prior to award, even though no actual need existed at that time. With much of the time-consuming processing accomplished, there would be a minimum of administrative delay if the applicant subsequently developed a need for SBA assistance.

Realistically, the Government cannot effectuate its policy of bolstering small-business participation in defense procurement merely by ensuring that a fair proportion of defense contracts is allocated to small business. Considering the complexity and the unique risks of defense procurement, as well as the serious economic consequences of a termination for default, financial assistance should be made readily available to the small-business contractor from the date of bidding for the contract to the time of final payment. As illustrated by the plight of Security Signals, this assistance is often unavailable at the time of greatest need.

IV. FINANCIAL INABILITY AND THE GOVERNMENT'S CONTRACTUAL RIGHT TO TERMINATE FOR DEFAULT

The Government's program of financial assistance to defense contractors is designed to minimize the risk of performance failures. However, when all sources of financial assistance have been exhausted and the contractor is still unable to perform, the military departments are authorized to terminate the contract for default and repurchase the necessary supplies from another source. The economic consequences of such action can be quite severe, particularly where a small-business contractor is involved. Consequently, it is important to examine rather closely the Government's contractual right to terminate for a default caused by financial inability.

All Defense Department fixed-price supply contracts—regardless of the method of award or the complexity of the procurement—must contain a standard default clause. The contractual right of

by production schedules ... arising under defense contracts.” Chermak, Contractor Financing, 18 Fed. B.J. 286, 294 (1958). The lending bank is normally secured by an assignment of contract proceeds.


93. A.S.P.R. § 8–707, 2 Gov't Cont. Rep. ¶ 32955 (1960). Because reference is made to specific provisions of the default clause throughout the remainder of this Article, the default clause is set out in its entirety in the Appendix to this Article. Consequently, statements based upon the language of the default clause are not documented in footnote form.

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the Government to terminate for default is defined in paragraph (a) of the default clause. Subparagraph (a)(i) provides that the Government may terminate the contract by written notice to the contractor "if the contractor fails to make delivery of the supplies . . . within the time specified [in the contract] . . . or any extension thereof. . . ." Subparagraph (a)(ii) provides termination authority "if the contractor fails to perform any of the other provisions of [the] . . . contract, or so fails to make progress as to endanger performance of [the] . . . contract in accordance with its terms. . . ." Terminations in accordance with subparagraph (a)(ii) are proper only if the contractor fails to cure the alleged defects in performance within 10 days after receiving written notice of them from the contracting officer.

Both varieties of default may be "excused" under paragraph (c) of the default clause. However, the Government’s basic right to terminate is not affected by this provision. Paragraph (c) merely provides that an "excused" contractor will not be charged for excess costs of repurchase—in which case the termination will be characterized as "for the convenience of the Government." 94

Paragraph (f) of the default clause states that the "rights and remedies of the Government provided in this clause shall not be exclusive and are in addition to any other rights and remedies provided by law or under this contract." This provision not only preserves the Government’s common-law right to terminate for breach of contract and seek damages, but also ensures that reliance by the Government upon paragraph (f) will not constitute action pursuant to the default clause.

The distinction between common-law termination and termination under the default clause is vital. If the Government terminates the contract for default under paragraph (a)—and the failure of performance is found to be not excusable—the Government has a contractual right to charge the excess costs of repurchase to the contractor’s account. 95 Such costs are measured by the difference


94. See Hofmann Indus., ASBCA Dec. No. 2367 (1955). Although paragraph (a) of the default clause states that "the Government may, subject to the provisions of paragraph (c) . . . terminate," paragraph (c) provides only that the contractor "shall not be liable for any excess costs if the failure to perform the contract" is excusable. If the cause of default is excusable, paragraph (e) directs that the termination shall be deemed to have been issued as a "Termination for Convenience of the Government." See A.S.P.R. § 8–701, 2 Gov’t Cont. Rep. ¶ 32948 (1959) (contractor entitled to costs and reasonable profit on work done). The contractor may attack the propriety of a paragraph (a) termination and argue the issue of excusability in a timely appeal to the ASBCA from the written notice of termination. Virginia Dare Extract Co., ASBCA Dec. No. 4916, 59–1 BCA 9560 (1959); Fulford Mfg., ASBCA Dec. Nos. 2143, 2144, 6 CCF ¶ 61815 (1955). See note 8 supra.

95. Paragraph (b) of the default clause provides that "the Government may
between contract price and repurchase price rather than by the rule applied to ordinary contractual damages under local law—normally, the difference between contract price and fair market value at the time of default.\textsuperscript{6} Further, excess costs may be collected through administrative proceedings rather than by obtaining a judgment in a court of competent jurisdiction. However, the entire process of termination and repurchase is subject to review by the ASBCA.\textsuperscript{7}

If the Government bases its termination upon the common-law rights reserved by paragraph (f) rather than upon the termination rights created by paragraph (a), there is no contractual right to charge the excess costs of repurchase to the contractor's account. In this circumstance, the Government must maintain an action for damages, the measure of which will be determined by local law. Another result of the Government's decision to terminate under its common-law rights reserved by paragraph (f) is that the ASBCA will have no jurisdiction to review the propriety of the termination.\textsuperscript{98}

With this background, let us reconsider the Security Signals case. Security Signals was 50,000 units behind schedule when its financial difficulties were first revealed to the Government. At this point, the Government could have terminated the contract under subparagraph (a)(i) of the default clause. Instead, the contracting officer elected to permit Security Signals to continue performance while procure, upon such terms and in such manner as the Contracting Officer may deem appropriate, supplies or services similar to those so terminated, and the contractor shall be liable to the Government for any excess costs for such similar supplies or services.

96. Eastern Tool & Mfg., ASBCA Dec. No. 4815, 58–2 BCA 7933 (1958). Since the Government often procures military supplies with no commercial counterparts, it may be difficult to calculate fair market value at the time of default. Paragraph (b), therefore, provides realistic flexibility in determining damages. See Van Cleve, "Similarity" and the Assessment of Excess Costs Under the Government Default Clause, 8 MILITARY L. REV. 147 (1960). The special rule of damages is not available if paragraph (b) is omitted from the contract, Iso Prods., ASBCA Dec. No. 879 (1953), or if paragraph (f) is used in lieu of paragraph (b), 34 DECS. COMP. GEN. 347 (1955).


efforts were being made to obtain financial assistance, but failed to set a new delivery schedule. The contracting officer's action—in legal effect—nullified the previous failure to deliver on time and, in the absence of a new delivery schedule, gave Security Signals a reasonable time in which to perform.99

By his own action, therefore, the contracting officer in Security Signals was placed in the difficult position of determining precisely when the Government's contractual right to terminate for default could again be exercised. Subparagraph (a)(i) was of no avail until Security Signals failed to perform under a new delivery schedule, and no such schedule had been established.100 Subparagraph (a)(ii) was equally ineffective because neither circumstance covered by subparagraph (a)(ii) existed at that time: There was no contract clause which required a certain level of financial resources to be maintained, so the lack of adequate working capital was not in itself a failure “to perform any of the other provisions” of the contract.101 Further, the fact that Security Signals was in poor financial condition did not necessarily “endanger performance” of the contract, so long as there was a reasonable possibility that assistance would soon be forthcoming.102

In short, the Government's contractual right to terminate for default may become elusive if the contracting officer decides to assist a defaulting contractor that is financially overextended to the point that it cannot commit itself to a specific delivery schedule. In the


101. See Bolinders Co., ASBCA Dec. No. 2457 (1955): There is no provision in the contract that requires appellant's ability financially to perform to be maintained at any particular standard and the decision . . . that appellant was in default merely by reason of the fact that it failed to show improvement in its financial ability, is in error.

102. Manhattan Lighting Equipment Co., ASBCA Dec. No. 5113, 60–1 BCA 13113 (1960). Whether a failure to make progress actually endangers performance may depend upon whether the contract calls for readily obtainable supplies or technically complicated articles of manufacture.
absence of an actual failure to deliver on time—in which case termination would be possible under subparagraph (a)(i)—the contracting officer normally cannot issue the 10-day notice which is prerequisite for default termination under subparagraph (a)(ii) until it is apparently impossible for the contractor to perform within the terms of the contract.

Even in a case in which a contractor admits its financial inability and repudiates the contract, it is not clear under the terms of subparagraph (a)(i) that default results. Thus, despite an urgent need for the supplies, the contracting officer in the Security Signals case did not terminate the contract until the 10-day notice requirement of subparagraph (a)(ii) had been satisfied. This hesitancy to terminate the contract for default is perhaps justified by a literal reading of the default clause, but it certainly is not well founded in the decisions of the ASBCA.

The logical starting point in a discussion of the ASBCA decisions is The Cowan Company,103 basically a “how not to do it” decision. In Cowan, the contractor repudiated several contracts less than 10 days before the first deliveries were due. Relying upon subparagraph (a)(i) in his written notice, the contracting officer immediately terminated the contracts for default and repurchased the supplies, charging excess costs to the contractor.

On appeal, the ASBCA held that the contract terminations and the subsequent assessments of excess costs were improper:

The contracting officer’s hasty actions in terminating the contracts prior to the time for performance cannot be justified on the theory of anticipatory breach since the method for termination of the contracts relied upon by the contracting officer is specifically set forth in subparagraph (a)(i) of the Default article. It is well settled that remedies exist for anticipatory breach of contract; the contracting officer, however, in this case chose to terminate the contracts pursuant to subparagraph (a)(i) of the Default article. In our opinion terminations of the contracts under the circumstances in this case were not authorized under the provisions of paragraph (a). . . . The assessment of excess costs of reprocurement is predicated on a proper exercise of the right to terminate as set forth in paragraph (c). . . . Since the terminations were not authorized, the Government’s rights to assess excess costs pursuant to paragraph (c) [now paragraph (b)] are precluded.104

104. Ibid. (Emphasis added.) The Cowan case was subsequently reconsidered by the ASBCA in an unpublished opinion dated January 24, 1956. In affirming its earlier decision, the ASBCA distinguished Belt-Rite Leather Goods, ASBCA Dec. No. 2473 (1955), a case which was decided after the original Cowan decision. The ASBCA had held in Belt-Rite that a contractor’s request for cancellation of its contract constituted a waiver of the 10-day notice requirement of subparagraph (a)(ii) of the default clause; consequently, the contracting officer’s action in terminating the contract was proper and the contractor was liable for excess costs of repurchase. In Cowan, however, the ASBCA found a repudiation rather than a request for cancellation, and since the delivery of a 10-day notice was “obviously impossible under the circumstances” of the Cowan case, the contractor’s repudiation
While Cowan's practical lesson for contract administrators is clear, its broader implication is that paragraph (a) provides no authority to terminate immediately for anticipatory repudiation. If this conclusion were valid, the contracting officer would be required to choose between issuing a 10-day notice and waiting until a failure to deliver actually occurs. However, this broader implication of Cowan has been effectively dispelled by a more recent decision, *The Aircraftsmen Company.*

In the Aircraftsmen case, the ASBCA approved the action of the contracting officer in terminating the contract forthwith when the contractor admitted its financial inability, even though there was arguably no default under subparagraph (a)(i). Although the contractor did not positively repudiate in Aircraftsmen, the ASBCA reasoned that admitted financial inability was tantamount to repudiation, giving the Government an immediate cause of action. The ASBCA did not identify the source of this cause of action, but merely distinguished Cowan as a case in which the contracting officer improperly relied upon subparagraph (a)(i) in an anticipatory breach situation. Thus jurisdiction was taken to examine the propriety of the termination without questioning whether the authority to terminate was derived from the contract or from the common-law

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did not constitute a waiver of notice. *But see* Trand Plastics Co., ASBCA Dec. No. 3708, 57–1 BCA 3297 (1957) (where repudiation is positive and unconditional, 10-day notice is a useless gesture which is not required).


106. In Greenstreet, Inc., ASBCA Dec. No. 3137, 59–1 BCA 8926 (1959), the contractor coupled a failure to deliver on time with financial inability as defined in Aircraftsmen. The ASBCA was correct in holding that the contract was properly terminated under subparagraph (a)(i), but confused the issue by references to anticipatory breach. From the standpoints of both practicality and theory, the contractor's failure to deliver on time in Greenstreet was a present breach rather than an anticipatory breach.

107. The classic case for application of the doctrine of anticipatory breach occurs when a promisor, without failing to render a promised performance and while there is yet performance due from the promisee, shows the promisee by word or deed that he is unwilling or unable to render a promised performance not yet due. See *Restatement, Contracts* § 318 (Supp. 1948); 5 *Williston, Contracts* § 1296 (2d ed. 1937). See Fairbanks & Speidel, *Anticipatory Breach—Contracting Officer's Dilemma,* 6 MILITARY L. REV. 129 (1959). For clear cases of repudiation, see David R. Levin, ASBCA Dec. No. 5077, 59–1 BCA 8702 (1959); Trand Plastics Co., ASBCA Dec. No. 3708, 57–1 BCA 3297 (1957); Old Home Milk Co., ASBCA Dec. Nos. 2594 & 2666 (1955); The Cowan Co., ASBCA Dec. Nos. 2373 & 2374, 6 CCF ¶ 61821 (1955). *But cf.* Manhattan Lighting Equipment Co., ASBCA Dec. No. 5119, 60–1 BCA 13113 (1960) (mere admission of financial hardship if performance were completed is not repudiation). The difficulty in Aircraftsmen was that the contractor, although financially incapacitated, did not repudiate the contract. However, it is possible to argue by analogy to insolvency cases that financial inability to perform—without actual repudiation of the contract—is sufficient to constitute a present, material breach of an implied promise not to become incapacitated from performing. See Central Trust Co. v. Chicago Auditorium Ass'n, 240 U.S. 581 (1916) (involuntary bankruptcy); Pennsylvania Exch. Bank v. United States, 170 F. Supp. 629 (Ct. Cl. 1959) (assignment for benefit of creditors).
rights reserved to the Government by paragraph (f) of the default clause. Yet, as was pointed out earlier, the ASBCA has no jurisdiction over controversies arising pursuant to paragraph (f) terminations.

In *David R. Levin*, the contractor agreed to make daily milk deliveries to an Army installation. After several deliveries had been made, the state milk commission suspended the contractor's license because of the very poor financial position of the contractor. Consequently, the contractor refused to make the remaining deliveries. Relying upon this refusal, the contracting officer—without any formal action—treated the contract as terminated and immediately established a new source of supply, at excess costs to the Government.

Upon appeal by the contractor, the ASBCA sustained the contracting officer's action as follows:

> There is no question as to whether the contractor was in default in view of its advice that its last delivery would be on 6 November 1957 because it was losing its licenses. As to the anticipatory breach aspect, see *Aircraftsmen*. The nature of the procurement and the necessity for a daily supply of milk at Fort Story fully justifies and explains the prompt action of the contracting officer in effecting reprocurement. In so doing the Government objectively treated the contractor's right to perform as terminated for default and acted in reliance on the contractor's admitted inability to perform. The [contractor's notice to the contracting officer] placed the contractor in a default status and in our opinion rendered a formal termination by the Government unnecessary in order for the contracting officer to treat the right to perform as terminated and to effect reprocurement.

In view of *Aircraftsmen* and *David R. Levin*, therefore, the admitted financial inability and repudiation by the contractor in *Security Signals* would have supported an immediate termination and repurchase by the contracting officer. It must be remembered, however, that such precipitate action is justifiable only when the contractor actually repudiates the contract or is obviously and positively incapacitated from performing in accordance with the contract.

The result reached by the ASBCA in *Aircraftsmen* and in *David R. Levin* is unquestionably sound from the standpoint of realistic contract administration, for if a contractor clearly will be unable to perform on time, the giving of a 10-day notice is a useless gesture.

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108. See note 98 supra and accompanying text.
110. Id. at 8705-06.
111. See note 107 supra.
While recognizing business realities, however, the ASBCA has neglected to explain the basis of its jurisdiction to consider the merits of both termination of contract and assessment of excess costs. Since the jurisdiction of the ASBCA is limited to matters arising from the contract itself, one might well conclude that the ASBCA has written into the default clause a “subparagraph (a)(iii),” which authorizes termination for “repudiation or admitted financial inability.” If the ASBCA’s decisions are to be explained on the basis of existing contract provisions, however, it seems better to theorize that the admission of financial inability and repudiation of a contract are so repugnant to the possibility of performance within the terms of the contract that the contractor may be deemed to have waived the 10-day notice requirement. Use of the waiver theory places termination authority in subparagraph (a) (ii), without unduly straining the jurisdiction of the ASBCA. It further reduces Cowan to merely a warning that subclause (a) (i) is not proper authority for termination in cases of repudiation prior to the delivery date.

V. Financial Inability and Excusable Cause

At the date of termination for default, Security Signals had a poor credit rating and less than $500 in cash. Further, it was contemplating the sale of capital equipment to finance the performance of two other Government contracts. In order to avoid excess costs of $12,071 and to obtain a “termination for convenience” settlement, Security Signals appealed to the ASBCA, arguing that its financial inability was due to causes beyond its control and without its fault or negligence.\(^{113}\) after the repudiation. See Paint & Pack Corp., ASBCA Dec. No. 1341 (1953). But cf. United States v. Seacoast Gas Co., 204 F.2d 709 (5th Cir. 1953), cert. denied, 346 U.S. 866 (1953) (Government gave contractor three days to retract repudiation, then elected to treat breach as final).

113. See note 94 supra. The contractor may raise the question of “excusability” under paragraph (c) of the default clause in a timely appeal from either the termination notice or the assessment of excess costs. Virginia Dare Extract Co., ASBCA Dec. No. 4916, 59–1 BCA 9560 (1959); Fulford Mfg., ASBCA Dec. Nos. 2143 & 2144, 6 CCF ¶ 61815 (1955). Cf. Oxygen Equipment Service, ASBCA Dec. No. 5690, 60–1 BCA 11843 (1960) (contractor must appeal within 30 days of assessment even though no express determination of inexcusability was made); Maudlin & Son, ASBCA Dec. No. 2097, 6 CCF ¶ 61610 (1954) (contractor must appeal from separate determination of inexcusability). Regardless of when the issue is raised, if the default was excusable the contractor is entitled to a termination-for-convenience settlement. Carl W. Schutter Indus., ASBCA Dec. No. 3867, 59–2 BCA 11120 (1959). The contractor may also question the propriety of the assessment of excess costs in a timely appeal from that determination. Maximoff Research Co., ASBCA Dec. No. 5074, 59–2 BCA 10234 (1959) (Government properly repurchased similar supplies and services); Office Equipment Co., ASBCA Dec. No. 5040, 59–2 BCA 10393 (1959) (Government failed to mitigate damages); Bar-Ray Prods.,
The ASBCA found that Security Signals' failure to perform was not excusable, and denied the appeal. The ASBCA's reasoning on this question was as follows:

In order to sustain this appeal, we would have to affirmatively find that the failure to perform arose out of causes beyond the control and without the fault or negligence of the appellant. We have studied the record carefully and are unable to make that finding. We are not persuaded that before bidding appellant made reasonable arrangements for financing should the contract be awarded, arrangements of such definiteness that they could reasonably be relied upon. Nor are we persuaded that the bank's actions after bid and award were due to causes beyond appellant's control and without appellant's fault or negligence.\[^{114}\]

In view of the economic impact of this decision upon Security Signals and its implications for other small-business contractors, a detailed examination of the excusability problem seems appropriate.

In approaching the problem of excusability, the primary legal question is the extent to which the Government has, by adopting the provisions of paragraph (c) of the default clause, assumed the risk of a contractor's financial inability to perform.\[^{115}\] The resolution of this question depends, first of all, upon a determination of whether the contractor has obtained resources which are adequate, in the light of business custom and practice, to finance all expected costs of performance.\[^{116}\] These resources may be obtained from private or governmental sources and may consist of either cash on hand or credit, but they must be available at the date of contract award.\[^{117}\]

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\[^{115}\] The purpose of the Government in assuming risks which would otherwise be on the contractor is to get the benefit of lower prices on its many defense contracts. United States v. Brooks-Callaway Co., 318 U.S. 120 (1943). Paragraph (c) of the current default clause for fixed-price supply contracts excuses certain performance failures which are "beyond the control and without the fault or negligence" of the contractor. See Appendix. Earlier versions of the default clause contained the additional requirement that the cause of default be "unforeseeable." This of course increased the difficulty of being excused for defaults caused by financial inability. See Oakland Truck Sales, ASBCA Dec. Nos. 560, 561, 573, 687 & 690 (1951); Modern Plastics Mfg., ASBCA Dec. No. 351 (1950). Cf. 39 Decs. Comp. Gen. 478 (1959).


\[^{117}\] It is believed to be settled law that financial weakness, existing at the time of bid and award, which would endanger performance, is not an excusable cause for failure to carry out the contract. The reason is self-evident. Such financial weakness should be remedied before the contract is made or if that is impossible the contract should not be executed.
If the ASBCA determines that the contractor did not have adequate financial resources at the time of award, a performance failure caused by financial inability will not be excused.\footnote{118}

If the contractor had adequate financing at the date of contract award, the next question is whether the deterioration of that condition was excusable. A prerequisite to excusability is that the financial deterioration produce complete inability to perform; if continued performance means only financial hardship or loss, the risk must be borne by the contractor.\footnote{119} Even if performance is impossible, the cause must be beyond the contractor's control and without its fault or negligence. Thus if financial inability is caused by negligent performance,\footnote{120} by mistakes in business judgment,\footnote{121} or by overextended capacity,\footnote{122} the default is not excusable.

In theory, financial inability which is caused either by any of several factors enumerated in paragraph (c) of the default clause or by similar factors ought to be excusable if beyond the contractor's control and without its fault or negligence.\footnote{123} In practice, however,

Machine Co., ASBCA Dec. No. 3214, 57-1 BCA 3863 (1957) (loan conditionally approved by the SBA); Valley Forge & Car Co., ASBCA Dec. No. 1924 (1956) (promise of bank to finance contract); Bernal Narrow Fabrics, ASBCA Dec. No. 1604 (1953) (promise by supplier to extend credit); West Coast Lumber Co., ASBCA Dec. No. 1131 (1951) (good credit, assignment of receivable to bank). \textit{But see} R. P. Bennett Co., ASBCA Dec. No. 3738, 57-1 BCA 3812 (1957) (firm commitment at time of award not sufficient to excuse default where bank was within rights in refusing to supply additional working capital).

There is a close parallel between the standard of excusability and that which ought to guide the contracting officer in his pre-award determination of financial responsibility. See text \textit{supra} at note 27.

\footnote{118} See, \textit{e.g.}, R. P. Bennett Co., \textit{supra} note 117; Newark Weaving Mills, ASBCA Dec. No. 3026, 6 CCF \textsection 61951 (1956).


\footnote{122} Selectar Indus., ASBCA Dec. No. 1635, 6 CCF \textsection 61769 (1953).

\footnote{123} No case has been discovered in which a contractor was excused for financial inability, except where the default was caused either by acts of the Government or by defaults of subcontractors. However, there have been decisions indicating that other causes would be recognized if properly presented to the ASBCA. See, \textit{e.g.}, Hercules Food Serv. Equip., ASBCA Dec. No. 3875, 57-1 BCA 4267 (1957) (no
the only causal factors accepted by the ASBCA have been two of the enumerated ones: "defaults of subcontractors," and "acts of the Government in either its sovereign or contractual capacity." 

A. Acts of the Government

When the finances of defense contractors are unstable, contract administrators have a difficult problem. Often, the thin line between default and successful performance is maintained only by the contracting officer's prompt and complete action, particularly where payment and financial assistance are involved. Nevertheless, a contractor may rightfully insist upon a high standard of contract administration. 

Thus, defaults caused by financial inability have been excused where the Government failed to pay invoices within a reasonable time, or where the Government improperly delayed evidence to support allegation that default was caused by strikes and work stoppages).


125. Q.V.S., Inc., ASBCA Dec. No. 3722, 58-2 BCA 8332 (1958) (improper progress-payment administration placed additional strain on contractor's already attenuated financial condition); Mifflinburg Body Works, ASBCA Dec. No. 723, 5 CCF 61276 (1951). In the case of Bolinders Co., ASBCA Dec. No. 2457 (1955), the Government was criticized for paradoxical conduct in dealing with a contractor in financial distress. (While suspending progress payments the contracting officer urged further performance, and while issuing a 10-day notice of termination he proposed a new delivery schedule.) However, the Bolinders decision was concerned with the propriety of a termination rather than excusability of an alleged default.

126. The importance of prompt partial payments to a contractor in financial distress is obvious. The Government, therefore, is under a duty to pay vouchers within a reasonable time. If an unwarranted delay causes financial inability, the contractor will be excused. See George E. Martin, ASBCA Dec. No. 3117 (1956) (delay of more than 30 days was unreasonable); Paint & Pack Corp., ASBCA Dec. No. 1341 (1953) (where contractor was on verge of financial inability. Government's remedy was termination for default, not the wrongful withholding of payments due). See also West Coast Lumber Co., ASBCA Dec. No. 1181 (1953); Mifflinburg Body Works, supra note 125. But see Oakland Truck Sales, ASBCA Dec. Nos. 560, 561, 573, 687, 690 (1951) (dictum that Government may withhold from payments due the contractor an amount equal to estimated excess costs of repurchase upon contractor's anticipated default).

The current "payments clause" for fixed-price supply contracts contains the following provision:

The Contractor shall be paid, upon the submission of proper invoices or vouchers, the prices stipulated herein for supplies delivered and accepted or services rendered and accepted, less deductions, if any, as herein provided. Unless otherwise specified, payment will be made on partial deliveries accepted by the Government when the amount due on such deliveries so warrants; or, when requested by the Contractor, payment for accepted partial deliveries shall be made whenever such payment would equal or exceed either $1,000 or 50 percent of the total amount of this contract.
or suspended promised financial assistance.\textsuperscript{127}

The language "acts of the Government" is not limited to the agency administering the contract, nor is it restricted to a particular contract. Financial inability has been excused where governmental agencies other than the military departments have failed to provide promised financial assistance to a defense contractor,\textsuperscript{128} or where improper administration of other Government contracts being performed by the contractor caused the default in question.\textsuperscript{129} The gist of these decisions is that if the Government obligates itself to provide a portion of the contractor's financial resources, any improper or dilatory contract administration which causes financial inability will excuse the default.

The Government's initial determination of "responsibility" is not an act which will excuse a subsequent default, for a defective determination does not breach any contractual duty to the prospective contractor. The Government determines financial responsibility prior to award in order to protect its own interest. Consequently, financial resources which were deemed adequate for a determination of responsibility may prove inadequate when the question of excusability arises; and the fact that the contract was awarded is not conclusive evidence of the contractor's financial ability to perform at the time

\begin{footnotes}
\item A.S.P.R. § 7–103.7, 2 Gov't Contr. Rep. ¶ 32670 (1960). Once the contract has been terminated for default, the Government, as a general creditor, has broad powers to set off the excess costs of repurchase against contract proceeds owed to the contractor. See United States v. Munsey Trust Co., 332 U.S. 234 (1947).
\item Q.V.S., Inc., ASBCA Dec. No. 3722, 58–2 BCA 8332 (1958). The Government's obligation is determined by the progress-payment clause contained in the prime contract. See A.S.P.R. app. E, § 510.1, 2 Gov't Contr. Rep. ¶ 35756.30 (1959). In Republican Electric & Mfg., ASBCA Dec. No. 4354, 59–1 BCA 9968 (1959), the contractor was performing as a prime contractor, and as a subcontractor for the Government. When the prime contract was terminated for financial inability, the contractor argued that the cause of default was the Government's failure to make prompt progress payments under the subcontract. The ASBCA rejected this argument on the ground that there was no privity of contract between the Government and the contractor in its capacity as a subcontractor. Consequently, there was no act of the Government in its contractual capacity.
\item Transportation Seat Co., ASBCA Dec. No. 2161, 59–1 BCA 8857 (1959) (RFC failed to pay promised loan, contractor not at fault); Typo Machine Co., ASBCA Dec. No. 3214, 57–1 BCA 3863 (1957) (SBA cancelled conditionally approved loan, contractor not at fault). Cf. Israel's Co., ASBCA Dec. No. 1222 (1953) (contractor argued that default was caused by Federal Reserve Board's increase of cash-reserve minimum for member banks, but ASBCA dismissed the appeal on other grounds).
\end{footnotes}
of award. The contractor cannot rely upon a determination of financial responsibility, but must re-establish the fact of adequate financing in excusability proceedings before the ASBCA.

B. Defaults of Subcontractors

One of the specifically enumerated causes upon which excusability may be predicated is "defaults of subcontractors." The type of subcontractor defaults with which the present discussion deals is comprised of those which affect the prime contractor's financial ability to perform. Typically, the issue arises when a subcontractor fails to render a promised performance, forcing the prime contractor to find an alternate source of supply. For a small-business prime contractor, performance may well be impossible if the price of the alternate supplier is excessively high, or if no other subcontractor can be found.

The ASBCA has consistently interpreted the default clause for fixed-price supply contracts in effect prior to January, 1958, to excuse prime-contractor performance failures which were caused by subcontractor defaults, provided only that those defaults were beyond the control and without the fault or negligence of the prime contractor; the fact that the subcontractor's default was not excusable was immaterial. The test applied by the ASBCA in evaluating

130. Although a contractor may be determined responsible and eligible for contract award, this does not enlarge its actual capabilities, alter its contractual responsibilities, or authorize extraneous relief from its financial inability. See Emeco Corp., ASBCA Dec. No. 4101, 59-2 BCA 10366 (1959) (SBA certificate of competency is not conclusive of credit responsibility in excusability proceeding before ASBCA); Trand Plastics Co., ASBCA Dec. No. 3708, 57-1 BCA 3297 (1957) (preaward survey is for benefit of Government and is not relevant in determination of excusability for default); Irwin Tool Co., ASBCA Dec. No. 2490, 6 CCF 61674 (1955) (assuming that contracting officer erred in his determination of responsibility, contractor knew more of its own financial condition and, by submitting a bid, knowingly invited error).

131. Emeco Corp., supra note 130.

132. Under paragraph (c) of the default clause, the prime contractor cannot argue that a performance failure was caused by "defaults of subcontractors" without first demonstrating that the supplies or services to be furnished by the subcontractor were not available from other sources in sufficient time to permit the contractor to meet the required delivery schedule. See United States v. Thompson, 168 F. Supp. 281 (N.D. W. Va. 1958), aff'd, 268 F.2d 426 (4th Cir. 1959).

133. Prior to January of 1958, the default clause provided that: The Contractor shall not be liable for any excess costs, if any failure to perform the contract arises out of causes beyond the control and without the fault or negligence of the Contractor. Such causes include, but are not restricted to . . . defaults of subcontractors due to any of such causes unless the Contracting Officer shall determine that the supplies or services to be furnished by the subcontractor were obtainable from other sources in sufficient time to permit the Contractor to meet the required delivery schedule. [Emphasis added.]

In John Andresen Co., ASBCA Dec. No. 633, 5 CCF 61182 (1950), the ASBCA interpreted this to mean that only the prime contractor's excusability was relevant, and that the causes of subcontractor defaults were not limited to those enumerated.
the prime contractor's conduct was simple: Looking at the subcontractor's business capacity, reliability, and general experience, would a sound business man have selected that subcontractor to perform the contract in question? A good illustration of the application of this test was provided by the case of Paromel Electronics Corporation.

Paromel, a small-business prime contractor, obtained a price quotation from a subcontractor and relied upon that quotation in submitting the low bid on a small-business "set-aside" contract. After the award was made to Paromel, the subcontractor discovered a pricing error, repudiated the original quotation, and increased the estimated price of performance. Unable to find an alternate source of supply at a lower price, and faced with bankruptcy if it attempted to perform, Paromel repudiated its contract with the Government. As a result, the Government terminated the contract for default, repurchased the supplies, and assessed excess costs of approximately $197,000.

On appeal by Paromel, the ASBCA found that in view of the facts prevailing at the time of bid and award Paromel had obtained adequate financing. Because Paromel's subsequent financial inability was caused by the supplier's unexpected repudiation — and because

in the default clause. In practical effect, if the subcontractor's default was beyond the prime contractor's control and without its fault or negligence, the prime contractor's default was excusable, even though the subcontractor's default was not excusable under the same standards. Accord, Firth Machine & Tool, ASBCA Dec. No. 4600, 59-2 BCA 10311 (1959); Emeco Corp., ASBCA Dec. No. 4101, 59-2 BCA 10366 (1959); Ross-Mehan Foundries, ASBCA Dec. No. 4823, 59-1 BCA 9077 (1959); Paromel Electronics Corp., ASBCA Dec. Nos. 4025 & 4123, 57-2 BCA 5216 (1957), motion for reconsideration denied, 58-2 BCA 7281 (1958).


136. At the time of contract award, Paromel's net worth was $50,000 and adequate financing had been obtained to perform at the original contract price. At the date of termination, Paromel's net worth was $30,000 and anticipated excess costs were $197,000.
Paromel had no reason to expect this conduct—the default was excusable.\(^{137}\)

In a motion for reconsideration, the Government argued that the ASBCA had given undue preference to a small business, for had a larger contractor been involved, the supplier's repudiation would have caused only financial hardship rather than a total inability to perform—in which case the contractor's default could not be excused.\(^{138}\) The ASBCA denied the Government's motion, reasoning that "if the Government, out of its concern for the welfare of small contractors, chooses to limit certain of its procurement to them to the exclusion of larger operators, it can scarcely close its eyes to the facts, the realities, and the hazards, implicit in its election to deal with small business under its uniform and unchanged contract provision."\(^{139}\)

The current default clause, as amended, would substantially change the result obtained in *Paromel Electronics* and similar cases. Under the amended clause, before the prime contractor's default can be excused, the underlying defaults of subcontractors must also be excusable within the meaning of paragraph (c).\(^{140}\) Perhaps, as one writer has suggested,\(^{141}\) the amended clause serves to prevent collusion between prime contractors and subcontractors in avoiding excess costs. But a literal application of the current clause may produce some undesirable results. Clearly, *Paromel Electronics*—and its realistic approach to the financial problems of small-business contractors—is overruled. Paromel's default would not be excused under the current default clause because the subcontractor's pricing error was within the control of the subcontractor and due to the

\(^{138}\) See note 119 *supra* and accompanying text.
\(^{140}\) Paragraph (c) of the current default clause provides that a prime contractor's failure to perform because of the default of a subcontractor will be excused only if the subcontractor's default "arises out of causes beyond the control of both the Contractor and the subcontractor, and without the fault or negligence of either of them. . . ." See Appendix. In the few decisions to date, the ASBCA has given effect to the literal meaning of the change. See Putnam Mills, ASBCA Dec. No. 5548, 60-1 BCA 11970 (1960); Michael A. Zielinski, ASBCA Dec. No. 5848, 60-1 BCA 12025 (1960); Alert Prods., ASBCA Dec. No. 5620, 59-2 BCA 11381 (1959). The default clause for fixed-price construction contracts was not amended, and still contains the same standards for excusing subcontractor defaults as did the old default clause for supply contracts. See A.S.P.R. § 8-709, 2 Gov'T Contr. Rep. § 32957 (1960). However, the General Accounting Office treats the construction-contract default clause as if it had been amended, and has rejected the *Andresen* interpretation. See 39 Decs. Comp. Gen. 343 (1959).
latter's fault or negligence. Thus, even though Paromel exercised good business judgment in selecting the subcontractor, it would (under the amended clause) be forced into bankruptcy by the Government's assessment of excess costs. 142

The effect of the excusability amendment is to make the prime contractor a virtual insurer of the selected subcontractor's business conduct. This might be unobjectionable if the prime contractor were permitted free and complete discretion in its selection of subcontractors. But the Government has gradually increased its control of the prime contractor's selection of subcontractors. The Government's control is manifested in specifications which require the selection of sole-source suppliers or limit the available sources of supply, and in regulations which reserve authority to approve the prime contractor's "make or buy" procurement program and to review the qualifications of individual subcontractors. 143 Further, the Government has been increasingly insistent that subcontracts be awarded to small businesses or to businesses in labor-surplus areas. 144 All of this Government control reduces the freedom of choice which a prime contractor ought to have in order to balance the risk of subcontractor defaults assumed by the prime contractor under the current default clause.

It is highly questionable whether any prime contractor—large or small—should be made to bear the consequences of a default by a subcontractor when the Government has either required the selection of that particular subcontractor or refused to approve suppliers chosen by the prime contractor. Admittedly, a major purpose of governmental control in this area is to reduce the risks of unrealistic pricing and of failures in performance; perhaps the prime contractor will benefit from this control in the long run. Nevertheless, the current default clause does not protect the prime contractor that has exercised good business judgment or has been required to

142. A firm price quotation is not essential to a determination of excusability of a subcontractor's default. The ASBCA has recognized that "in order to obtain 'firm' commitments the bidder would normally be obliged also to commit itself unconditionally to acceptance before it knows whether it will receive a contract or not. Such business dealing would be not only improvident but, as to small operators, nothing short of suicidal." Paromel Electronics Corp., ASBCA Dec. Nos. 4025 & 4123, 58-2 BCA 7281, 7282 (1958). See also Arlington Sales Agency, ASBCA Dec. No. 1704 (1954). For an indication of the flexibility permitted in the pre-award price quotations of subcontractors, see 39 DECS. COMP. GEN. 343 (1959). The subcontractor may be liable to the prime contractor for damages if the pre-award bid is repudiated after the prime contractor has relied thereon and received the contract award. Heifetz Metal Co. v. Peter Kiewit Sons, 264 F.2d 495 (8th Cir. 1959); Hickerson v. Logan-Long Co., 183 F. Supp. 562 (S.D. Ohio 1960).

143. See notes 21 & 22 supra.

select a supplier of questionable ability. Large prime contractors can compensate for losses sustained as a result of subcontractor defaults by the simple expedient of raising their bids on future contracts. For the small-business prime contractor, however, one costly default may make subsequent participation in defense procurement impossible.

C. Security Signals in Perspective

In Security Signals, the ASBCA determined that “before bidding [the contractor had not] . . . made reasonable arrangements for financing should the contract be awarded, arrangements of such definiteness that they could reasonably be relied upon.” Accepting the ASBCA's factual determination, its allocation of costs appears sound. The Government, regardless of its sympathy with small business, should not be required to absorb the risk of dealing with poorly financed contractors—and this risk is undoubtedly increased when a definite commitment for financing has not been obtained at the time of contract award. However, the ASBCA's apparent emphasis upon arrangements at the time of bidding seems misplaced. While it may be wise to have financing when the bid is submitted, the crucial date for purposes of excusability is the date of award. Clearly, the fact that a contractor had no reasonable arrangements for financing at the time of bidding would not preclude a finding of excusability if financing had in fact been obtained prior to award.

After determining that Security Signals did not have adequate arrangements for financing at the time of bidding, the ASBCA went on to find that the bank's post-award refusal to provide financing did not excuse the contractor's financial inability to perform. This suggests that if the bank's refusal had been an excusable cause of default, the appeal would have been sustained—despite the fact that Security Signals did not have adequate financing at the time of award. In view of prior decisions, however, the finding of inadequate financing at the time of award made it unnecessary to consider whether Security Signals' failure to obtain financing after award was excusable.

For purposes of excusability, therefore, if a contractor has not obtained reasonably reliable financing by the time of award, that contractor has not satisfied its contractual responsibility. This holds true although the contractor had been determined financially responsible for purposes of award and was later prevented from ob-

146. See note 117 supra and accompanying text. See also notes 15 & 17 supra.
148. See note 118 supra and accompanying text.
taining working capital solely by causes beyond its control and without its fault or negligence. Even if financial arrangements have been obtained at the time of award, the ASBCA has excused the defaults of prime contractors only when those defaults stemmed from "acts of the Government in its contractual capacity" or from "defaults of subcontractors"—and recent amendment of the default clause has reduced the protective effect of the latter cause.

The foregoing discussion suggests an interesting—albeit hypothetical—question regarding the Security Signals case. Suppose that Security Signals had obtained a definite commitment from the bank prior to award of the contract, and that Security Signals' subsequent failure to obtain working capital was beyond its control and without its fault or negligence. Would the wrongful act of a commercial bank constitute an excusable cause under paragraph (c) of the default clause? The default clause specifically states that the excusable causes of default are not restricted to those enumerated in paragraph (c). Therefore, if a non-enumerated cause is alleged by the prime contractor in its excusability appeal, the immediate question for the ASBCA is whether the cause alleged can be equated to any of those which are enumerated.140

Unfortunately, there is very little basis for comparison between "acts of a commercial bank" and the specific circumstances listed in paragraph (c) of the default clause. Consequently, if the excusability of a non-enumerated cause of default is not to be settled by a mechanical exercise in semantics, the ASBCA must look to the policies underlying Government procurement. For example, the ASBCA ought to consider whether governmental absorption of the risk involved will result in lower bids on future contracts. More important, the ASBCA ought to examine closely the immediate effect upon the contractor of a negative determination of excusability. If the ASBCA determines that "acts of a commercial bank" constitute an inexcusable cause of default, it automatically favors the contractor that is wholly reliant upon Government financing over the contractor that has secured private financing—for if financing is subsequently denied wrongfully to both contractors, the former will be excused while the latter is left to bear the burden of excess costs and the stigma of default termination. This result is certainly at variance with the Government's policy of encouraging contractors to rely primarily upon private financing.

Although the precise issue has not yet been presented to the ASBCA, it is suggested that if a contractor has been able to obtain adequate financial resources which later are wrongfully withheld,
default attributable to the latter cause ought to be excused. It may not be easy to justify such a decision in terms of lower contract prices to the Government, but if the Government is to keep faith with those small-business contractors which have honestly endeavored to perform without governmental assistance, there can be no other decision.

VI. Conclusion

In March of 1957, Security Signals Corporation—a small-business prime contractor of demonstrated ability—had a cash position of $30,000, enjoyed a harmonious relationship with a bank which had provided working capital on several occasions, and was successfully performing two defense contracts. Six months later, Security Signals had less than $500 in cash, possessed no credit, owed the Government approximately $12,000 for excess costs of reprocurement, and was forced to sell capital equipment to remain in business. The primary cause of this financial deterioration was a lack of adequate working capital.

Security Signals made a fatal error in not obtaining a firm commitment for financing from the bank prior to contract award. The "harmonious relationship" with the bank could not be expected to survive Security Signals' insistence upon making capital improvements of which the bank disapproved, and especially was this true in the period of tight money which then prevailed. As a result, Security Signals was inadequately financed at the time of award and was, as a consequence, contractually liable to the Government for excess costs. The practical lesson to be drawn from this case study is that a small-business prime contractor should never undertake a Defense Department fixed-price supply contract unless adequate, firm commitments for financing have been obtained, whether from private or governmental sources.

Why did the Government's program of financial assistance fail in the Security Signals case? The obvious answer is that Government assistance was first requested at a time when governmental aid was either imprudent or impossible. Defense-contract financing was denied by the Government because the danger of monetary loss outweighed the probability of successful performance. The Small Business Administration (SBA) could not move fast enough to prevent a termination for default. In view of the purpose of defense-contract financing—which is to assure timely performance at the lowest possible cost—the Government's denial of this type of financial assistance cannot be severely criticized. Considering the broader purpose of SBA financial assistance to small business, however, the inability of this contractor to receive a timely decision from the SBA on the loan application was unfortunate.
Equally unfortunate is the fact that if Security Signals had chosen to ask the Government for financial assistance prior to award, most forms of defense-contract financing would have been available and could have been adapted to meet increased needs during performance of the contract. From this state of affairs emerges the distinct possibility that a contractor which has successfully obtained private financing for a Government contract may be in more difficulty, should financial difficulties arise during performance of its contract, than a contractor which — through necessity or design — has relied upon Government financing from the very beginning. This anomaly persists despite the Government's avowed preference for private financing at reasonable rates.

Although the Government was not contractually responsible for the default of Security Signals, the Government contributed to that default by acts and omissions which were outside its contractual capacity. One such governmental act was that of the contracting officer in determining that Security Signals was a responsible bidder, thereby permitting Security Signals to undertake performance without an adequate, firm, financial arrangement. Arguably, the facts provided a reasonable basis for this administrative action. Further, a rejection of Security Signals as not responsible would have required thorough documentation of the contracting officer's action and submission of the case to the SBA — both of which are time consuming processes. Regardless of these factors, however, the interests of both the Government and the small-business contractor would be better protected if a commitment or explicit arrangement for financing were required at the pre-award determination of responsibility. The importance of an adequate, pre-award financial evaluation by the contracting officer cannot be overemphasized.

Another governmental act or omission instrumental in Security Signals' default was attributable to the SBA, rather than to the military department administering the contract. A prospective small-business defense contractor which cannot obtain private financing may apply to the SBA for either a participation or a direct loan. If not discouraged by the two- to six-month processing delay, the applicant has better than a 50-per-cent chance of success. However, SBA assistance is unavailable if actual need does not exist, and — as Security Signals demonstrates — if that need first arises during performance of the contract, the SBA may be unable to act with sufficient dispatch to save the contractor from default.

It is apparent that SBA financial assistance is of limited value to the small-business contractor that obtains private financing prior to award and then develops an acute need for financing during actual performance of the contract. To fill this gap in the Government's over-all program of financial aid to small businesses, the SBA should
consider the adoption of a new procedure for financing small businesses engaged in the performance of defense contracts. A prospective prime contractor or subcontractor should be permitted to apply for a conditional loan without having to show actual need. The application would be processed immediately, policy decisions would be made, and the loan would be conditionally approved in the estimated amount required to finance performance of the contract in question. If private financing subsequently proved inadequate, the SBA—after quickly updating the contractor’s financial condition—could then make a direct loan of working capital to the extent of the contractor’s actual need for working capital.

The primary goal of Government financial assistance is to obtain the timely delivery of quality supplies at a reasonable price. When a small-business contractor is involved, the achievement of this goal requires prompt and conscientious action by contract administrators and demands the full utilization of the SBA’s potential. If participation in defense procurement is to benefit small business, the Government’s concern for the welfare of small business must not stop with the award of a contract. This point is strikingly illustrated by the Security Signals case. The military department involved in that case permitted an inadequately financed, small-business contractor to undertake performance of the contract, and subsequently determined that it was imprudent to help the contractor out of its financial difficulties. Even more disturbing was the SBA’s inability to reach a timely decision on the merits of Security Signals’ request for assistance. It is indeed strange that the very agency which was created by Congress to foster and protect small business should be unable to provide financial assistance at the time when it is needed most—at the critical stage where Defense Department financing is imprudent and private financing unavailable. In the Security Signals case, this failure resulted in the default and near-bankruptcy of a capable, small-business contractor.

APPENDIX

8–707 Default Clause for Fixed-Price Supply Contracts.
The following clause shall be used in all fixed-price supply contracts as defined in ASPR 7–102.

DEFAULT

(a) The Government may, subject to the provisions of paragraph (c) below, by written notice of default to the Contractor, terminate the whole or any part of this contract in any one of the following circumstances:

(i) if the Contractor fails to make delivery of the supplies or to perform the services within the time specified herein or any extension thereof; or

(ii) if the Contractor fails to perform any of the other provisions of this contract, or so fails to make progress as to endanger performance of this contract in accordance with its terms, and in either of these two circumstances does not
cure such failure within a period of 10 days (or such longer period as the Contracting Officer may authorize in writing) after receipt of notice from the Contracting Officer specifying such failure.

(b) In the event the Government terminates this contract in whole or in part as provided in paragraph (a) of this clause, the Government may procure, upon such terms and in such manner as the Contracting Officer may deem appropriate, supplies or services similar to those so terminated, and the Contractor shall be liable to the Government for any excess costs for such similar supplies or services: Provided, That the Contractor shall continue the performance of this contract to the extent not terminated under the provisions of this clause.

(c) Except with respect to defaults of subcontractors, the Contractor shall not be liable for any excess costs if the failure to perform the contract arises out of causes beyond the control and without the fault or negligence of the Contractor. Such causes may include, but are not restricted to, acts of God or of the public enemy, acts of the Government in either its sovereign or contractual capacity, fires, floods, epidemics, quarantine restrictions, strikes, freight embargoes, and unusually severe weather; but in every case the failure to perform must be beyond the control and without the fault or negligence of the Contractor. If the failure to perform is caused by the default of a subcontractor, and if such default arises out of causes beyond the control of both the Contractor and subcontractor, and without the fault or negligence of either of them, the Contractor shall not be liable for any excess costs for failure to perform, unless the supplies or services to be furnished by the subcontractor were obtainable from other sources in sufficient time to permit the Contractor to meet the required delivery schedule.

(d) If this contract is terminated as provided in paragraph (a) of this clause, the Government, in addition to any other rights provided in this clause, may require the Contractor to transfer title and deliver to the Government, in the manner and to the extent directed by the Contracting Officer, (i) any completed supplies, and (ii) such partially completed supplies and materials, parts, tools, dies, jigs, fixtures, plans, drawings, information, and contract rights (hereinafter called "manufacturing materials") as the Contractor has specifically produced or specifically acquired for the performance of such part of this contract as has been terminated; and the Contractor shall, upon direction of the Contracting Officer, protect and preserve property in possession of the Contractor in which the Government has an interest. Payment for completed supplies delivered to and accepted by the Government shall be at the contract price. Payment for manufacturing materials delivered to and accepted by the Government and for the protection and preservation of property shall be in an amount agreed upon by the Contractor and Contracting Officer; failure to agree to such amount shall be a dispute concerning a question of fact within the meaning of the clause of this contract entitled "Dispute."

(e) If, after notice of termination of this contract under the provisions of paragraph (a) of this clause, it is determined that the failure to perform this contract is due to causes beyond the control and without the fault or negligence of the Contractor or subcontractor pursuant to the provisions of paragraph (c) of this clause, such notice of default shall be deemed to have been issued pursuant to the clause of this contract entitled "Termination for Convenience of the Government," and the rights and obligations of the parties hereto shall in such event be governed by such clause. (Except as otherwise provided in this contract, this paragraph (e) applies only if this contract contains such clause.)

(f) The rights and remedies of the Government provided in this clause shall not be exclusive and are in addition to any other rights and remedies provided by law or under this contract.