BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

201

R-831

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

May 10, 1941

Dear Sir:

The President of the United States on April 29, 1941, approved an Act (Public Law 43--77th Congress) to expedite the national defense by authorizing the Secretary of War or the Secretary of the Navy, in their discretion, to waive the requirement contained in the Act of August 24, 1935 for performance and payment bonds in connection with supply contracts for the manufacturing, producing, furnishing, construction, alteration, repair, processing or assembling of vessels, aircraft, munitions, materiel or supplies of any kind or nature for the Army or the Navy. The Act of August 24, 1935, known as the Miller Act, requires in certain circumstances performance and payment bonds in the case of contracts exceeding $2,000.

A copy of Public Law 43 is enclosed. There is also enclosed a statement published at page 3106 of the Congressional Record for April 4, 1941, explaining the purpose of this legislation. This statement does not refer to the Secretary of the Navy but subsequent to its publication the bill was amended so as also to authorize the Secretary of the Navy to waive the requirement of performance and payment bonds.

Very truly yours,

Ernest G. Draper

Ernest G. Draper

Enclosures 2

TO PRESIDENTS OF ALL FEDERAL RESERVE BANKS
COPY TO FEDERAL RESERVE DEFENSE CONTRACT OFFICERS

[PUBLIC LAW 43--77th CONGRESS]
[CHAPTER 81--1st SESSION]
[S. 1059]

AN ACT

To expedite the national defense by clarifying the application of the Act of August 24, 1935 (49 Stat. 793), as to the requirement of mandatory performance and payment bonds in connection with supply contracts.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Act of August 24, 1935 (49 Stat. 793), may, in the discretion of the Secretary of War or the Secretary of the Navy, be waived with respect to contracts for the manufacturing, producing, furnishing, construction, alteration, repair, processing, or assembling of vessels, aircraft, munitions, materiel, or supplies of any kind or nature for the Army or the Navy, regardless of the terms of such contracts as to payment or title: Provided, That as to contracts of a nature which, at the date of the passage of this Act, would have been subject to the provisions of the Act of August 24, 1935 (49 Stat. 793), the Secretary of War or the Secretary of the Navy may require performance and payment bonds as provided by said Act.

Approved, April 29, 1941.

CONGRESSIONAL RECORD — SENATE

April 4, 1941, Page 3106

STATEMENT WITH RESPECT TO S. 1059

Section 1a of the act of August 24, 1935 (49 Stat. 793), commonly known as the Miller Act, provides that "before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work" is awarded, the contractor shall furnish a performance bond for the protection of the United States, in an amount satisfactory to the contracting officer, and a payment bond, for the protection of persons supplying labor and material in the prosecution of the work, with sureties satisfactory to the contracting officer and in an amount specified in the statute. It is customary to require performance bonds in an amount at least equal to 10 percent of the contract price. Payment bonds must by statute be in penal amount equal to 50 percent of the cost of the work in contracts below $1,000,000; 40 percent for contracts from $1,000,000 to $5,000,000, and in penal amount of at least $2,500,000 in larger contracts. From the phraseology, "public building or public work" of the act, it would appear that the requirement for these bonds was intended to relate only to contracts for buildings, river and harbor improvements, camps, cantonments, and such other real estate projects, or the alteration or repair thereof.

In construing the act of August 1, 1892, known as the Heard Act, the predecessor of the Miller Act, the Supreme Court of the United States, in 1910, held that a boat was a public work, and that whether a work is "public" or not does not depend upon its being attached to the soil, but, if it belongs to the representatives of the public, it is a "public work." Following that reasoning, the Attorney General of the United States, in 1932, expressed the opinion that work on a vessel owned by the United States was a public work within the meaning of the act. Again in 1936, the Attorney General ruled that contracts exceeding $2,000 in amount, for the alteration or repair of United States Coast Guard vessels, boats, and aircraft, since the property belongs to the United States, were contracts for public work. He further stated that contracts for the construction of such craft which provide for the passing of title to the United States during the progress of the work as partial payments are made are within the meaning of the term "any public work." Extending the analogy, he held the same year that a contract for making cotton mattresses from materials owned by the Government was public work.

It was but a step further for the Comptroller General to find that any Army contracts for supplies which provide for partial payments as the work progresses are contracts for public work, since title passes to the Government when the first partial payment is made, requiring performance and payment bonds under the Miller Act. By this reasoning, all sorts of contracts involving partial payments for supplying aircraft, machine guns, tanks, clothing, neckties, shoe laces, and other articles, must be classified as contracts for public works, making it incumbent upon the contractor, no matter what his financial strength may be, or whether the bonds are deemed to be necessary for the protection of the United States, or of laborers and materialmen, to furnish the performance and payment bonds specified by the Miller Act. The decisions of the Supreme Court, the Attorney General, and the Comptroller General are binding upon the War Department, and compliance therewith is mandatory. The same reasoning did not apply to Navy contracts since they only take a legal lien (under a statute passed in 1911) instead of title when partial payments are made.

Believing that Congress originally intended that the Heard Act and later the Miller Act should apply only to construction contracts, the War Department has submitted to the Congress a draft of legislation designed to clarify the meaning and application of the Miller Act to make it inapplicable to supply contracts for the Army. The proposed legislation was embodied in S. 1059, the present bill, as originally introduced. It was the view of the committee, however, that to center responsibility it would be better to permit the Secretary of War, in his discretion, to waive the requirements of the Miller Act as to bonds, so that the bill was amended and reported in its present form. The proposed act does not affect construction contracts.

NECESSITY FOR SUCH LEGISLATION

The national-defense program, calling for almost unheard-of quantities of material and equipment for the men entering the military service by voluntary enlistment and by induction under the Selective Service Act, the manufacture and construction of aircraft, munitions, tanks, guns, and supplies of every sort, has taxed the industrial resources of the United States to such an extent that private capital is unable to finance to completion thousands of supply contracts, many of them running into forty or fifty millions of dollars each. Increased facilities must first be constructed, new machinery purchased, and countless new employees engaged. The contractor then finds his resources expended and must seek additional financing of his Government supply contracts on a scale never before encountered. To meet this situation the Government has provided for advance payments, when necessary, at the beginning of the contract, and partial payments as the work progresses, to simplify private financing.

As a result, however, of the interpretation given the Miller Act, an inconsistent situation has grown up. If by the terms of a contract, 100 airplanes are paid for on completion of the contract, no Miller Act bond is required. If 100 airplanes are paid for as each airplane is delivered, no Miller Act bond is required. If the contract is let on a cost-plus-a-fixed-fee basis, no Miller Act bond is required. If, however, partial payments are made on a lump-sum contract to help the contractor finance the work in progress prior to its delivery, Miller Act bonds must be supplied. This mandatory requirement for performance and payment bonds where partial payments are made to help finance the work in progress has resulted in serious difficulties and delays in the financing and progress of the defense program.

The final execution and approval of a number of large aircraft contracts has been delayed from 2 to 5 months because of the inability of certain companies to obtain Miller Act bonds.

In some cases as many as 13 or more bonding companies have had to be called upon to provide a single bond, necessitating sending it from place to place for signature. In other cases the Government waited while the surety company made a long financial investigation and extracted the last ounce of security from the contractor's free assets. In some cases the contract had to be rewritten on a cost-plus-a-fixed-fee basis or with partial payments eliminated so that bonds could be waived. In one case a contract for $13,115,138.13 for furnishing 341 airplanes was executed September 14, 1940. It was not possible for the contractor, a reliable but tremendously expanded corporation, to furnish the necessary bonds. The bond requirement was finally removed in February 1941 by elimating the partial payments provided by the contract, resulting in a delay of 5 months before a complete contract could be obtained. With the elimination of partial payments, financing to a total of $6,000,000 was needed to finance this contract to the delivery stage.

In another instance, involving an original contract and a change order for 3,000 airplanes, at a total cost of $34,717,082.50, a delay of 6 months occurred before a legal contract could be finally approved, and it was necessary to eliminate partial payments by appropriate change order because no bonds could be furnished. Such examples might be multiplied many times.

The other side of the picture involves difficulties that have occurred when bonds have been furnished.

In many instances surety companies, claiming to be financing institutions within the meaning of the Assignment of Claims Act of 1940

(Public, No. 811, 76th Cong.), are requiring contractors to give them assignments of all rights under supply contracts on which bonds are given. If a bank loan is necessary to enable the contractor to finance his work and an assignment to the bank is contrmplated, the fact that the bonding company claims a priority hampers bank financing. Although the Judge Advocate General of the Army has ruled that bonding companies are not financing institutions within the meaning of the Assignment of Claims Act of 1940, nevertheless many banks are reluctant to make defense loans in the face of prospective litigation with a surety company. In this situtation, the Government supply contractor meets practically insurmountable obstacles in getting private financing.

Other surety companies are demanding from contractors indemnity for the bonds written by them and are requiring the deposit of collateral security or the giving of mortgages or other liens on the contractor's plant and equipment. This practically strips the contractor of available bankable security when a loan is necessary to finance operations under the contract.

The use of partial payments, because of the necessity for giving performance and payment bonds under the Miller Act, has been practically discontinued by the War Department as a means of financing Ordnance contracts and some Air Corps contracts. Frequently, if partial payments are not used, the contractor must have financing up to 50 or 60 percent of the amount of his contract prior to receiving payments from the Government for articles completed. Banks hesitate to make loans in such amounts. Advance payments under existing law are authorized only up to 30 percent of the amount of the contract. If the Government makes an advance of 30 percent, the banks necessarily feel that they are not required to make loans to take up 50 or 60 percent, because their claims are subordinate to the advance payment. These are practical difficulties experienced in financing contracts for carrying out the defense program.

In endeavoring to solve the difficulties in obtaining bonds for large Air Corps contracts, reduction in the penalties of performance bonds to 5 percent of the total contract price was attempted by the War Department. This resulted in refusal by the surety companies to give performance bonds to small contractors because the business was not considered sufficiently profitable or attractive. This situation compelled the Air Corps contracting officers to the penal amount of the performance bonds at the dictation of the surety companies.

Surety companies have, in some instances, required agreements from contractors to the effect that no more contracts will be undertaken until the ones on which bonds already have been written are

completed. In one case a surety company refused to write additional bonds until an existing contract was completed, with the result that the contractor was too late to bid on pending invitations and lost the opportunity to undertake additional defense work. Necessarily, this resulted in retarding and delaying procurement under the national-defense program. How many other instances of this kind actually exist is not known, but they are constantly being mentioned orally to contracting officers. Written complaints are stated by an Air Corps report to be relatively few for fear of black list.

The original purpose of the Miller Act was to protect laborers and materialmen with respect to Government construction projects, since no mechanics' or materialmen's liens attach because of Government ownership. Ordinarily lien protection does not exist and is not needed with respect to contracts for supplies, as distinguished from construction, between private individuals in the business world. Necessarily, the producer or manufacturer must pay his laborers weekly or at least twice monthly. It is the last claim he fails to pay. The individual labor claim, therefore, if any, is small in event of bankruptcy and has a priority there. There seems to be little logic in requiring payment bonds for laborers employed by contractors with the Government, when such laborers are protected by the Fair Labor Standards Act, the Walsh-Healey Act, and the Bacon-Davis Act as to wages, hours of labor, and methods and times of payment.

Likewise, materials usually are sold on a 30- to 60-day basis, cash on delivery, or only after satisfactory assurance of sound credit standing on the part of the purchaser. Materialmen can protect themselves and are better protected by adequate financing of the contractor insuring performance of the contract than by bonds. With respect to performance bonds for the protection of the United States, it may be said that the Government is its own insurer in other matters, and there is little likelihood of substantial loss in connection with the furnishing of supplies payable on the installment plan, since the payments do not exceed work successfully nearing completion.

The need for legislation such as S. 1059 is considered by the War Department to be urgently needed at this time in order properly to expedite the national-defense program under the new appropriation acts. The bill as reported would permit the Secretary of War to require performance and payment bonds in any case of supply contracts where he deems them to be necessary. The War Department requires performance bonds in many cases where that requirement is not mandatory by law, and S. 1059 as reported would permit the same practice with respect to the bonds that would be authorized to be waived thereunder when the interests of the Government so require.