

# **HIGHWAY RESEARCH RECORD**

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## Foreword

This RECORD consists of 9 papers which treat of different subject matters. They comprise and include papers relating to highway construction contracts and contractors' claims arising thereunder; quality control in highway contract administration; the enforcement of the anti-trust laws as bearing on construction contracts and highway construction; discussions of valuation problems in eminent domain; and an analysis of certain aspects of appraisal theory and practice. The papers were presented at sessions of the Workshop on Highway Law and have been selected for publication as being meritorious and useful treatments of the subjects.

The first paper, by Paul J. Andrews, involves the use of the construction contract as a means of implementing objectives of national policy. He discusses the numerous requirements of construction contracts involving Federal funds which are imposed on the contractor (without arm's length bargaining) for the purpose of securing compliance with the economic, social or other policy objectives of the Federal Government. The second paper, by Dowell H. Anders, closely related in nature, deals with the anti-discrimination provisions of construction contracts involving Federal funds.

The next two papers deal with contractors' claims. Murrey T. Berman's paper approaches the subject matter from the standpoint of the contractor; that is, he discusses what the contractor considers to be hardships imposed on him by the provisions of the standard contract in respect to matters including representations as to subsurface conditions, burdens arising from lack of a clear job site, and lack of a changed conditions clause in numerous such contracts. Dowell H. Anders in discussing contractors' claims deals both with ways and means to the avoidance thereof, and the proper method of presentation to the Federal Government where participation is sought in connection with a claim awarded at the state level.

Duke W. Dunbar, Attorney General of Colorado, discusses the important matter of quality control in highway contract administration. Melvin G. Dakin, of the Louisiana State University Law School, writes on the enforcement of the anti-trust laws and discusses significant cases and the import thereof with respect to highway construction.

The remaining papers deal with eminent domain and appraisal. Glenn H. Jacobson writes on the troublesome problem of valuation of leasehold estate in condemnation. Joseph Kuehnle deals with the developing and increasingly important subject of air rights and the valuation of air space.

In the last paper, A. G. Borgman writes informatively on the rendering of appraisal testimony from the point of view of the professional appraiser on the witness stand.

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# Policy Features of Highway Contracts

PAUL J. ANDREWS, Assistant General Counsel, Bureau of Public Roads

•IN order to avert a nationwide steel strike in April 1952, which he believed would jeopardize the national defense, the President issued Executive Order 10340 directing the Secretary of Commerce to seize and operate most of the steel mills of the nation. The Supreme Court of the United States, in the case of *Youngstown Sheet and Tube Company et al. v. Sawyer*<sup>1</sup> upheld the granting of an injunction against the Secretary of Commerce for such seizure. Mr. Justice Black, in the course of delivering the opinion of the Court, made the following comments pertinent to this discussion:

The President's power, if any, to issue the order must stem from an Act of Congress or from the Constitution itself.

\* \* \*

In the framework of our Constitution, the President's power to see that the laws are faithfully executed refutes the idea that he is to be a lawmaker.

\* \* \*

And the Constitution is neither silent nor equivocal about who shall make laws which the President is to execute. The first section of the first article says that "all legislative power herein granted shall be vested in the Congress of the United States . . . ." After granting many powers to the Congress, Article I goes on to provide that Congress may "make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof."

The President's order does not direct that a congressional policy be executed in a manner prescribed by Congress—it directs that the Presidential policy be executed in a manner prescribed by the President . . . . The power of Congress to adopt such public policies as those proclaimed by the order is beyond question . . . . The Constitution does not subject this lawmaking power of Congress to Presidential or military supervision or control.

In essence the Court was again addressing itself to the principles of constitutional law that the exercise of power by the Federal Government must be traced to some grant of power in the Constitution; and that the Constitution has established the Congress of the United States as the legislative body for the enactment of the laws and the President of the United States for the execution thereof. In the light of these principles let us examine the national policy aspects of the Bureau's required provisions for Federal-aid highway construction contracts.

The affirmative use of the Government contract as a means of pursuing national policy objectives is not of recent origin; but its use to proliferate such objectives has

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<sup>1</sup>*Youngstown Sheet and Tube Company, et al. v. Sawyer*, 343 U.S. 579, 585-588, 72 S.Ct. 863, 96 L.Ed. 1153, 26 A.L.R.2d 1378.



become increasingly popular and is apparent testimony to its success.<sup>2</sup> The continuing protective attitude of the Comptroller General, the Federal Government's accounting officer and the Congressional watchdog over the Executive Departments, has evoked many policy requirements in executive orders and agency regulations and directives which are designed primarily to insure the proper payment of Federal funds.<sup>3</sup> But, whether established by legislative enactment, executive order, or administrative regulation, the current Federal-aid highway construction contract, like its counterpart, the Federal construction contract, contains many terms and conditions (the so-called "boiler-plate" provisions) which are basically designed to advance some national economic, social or political policy of the Federal Government.

It has been argued, forcefully, by some writers that contracting by a private firm with the Federal Government is, to a large extent, an act of submission, rather than one of assent or mutual agreement.<sup>4</sup> The frustration of private contractors when first faced with these "boiler-plate" provisions may be understandable. But, this frustration should, in fairness, be tempered by the recognition that all competitors for Government business are similarly affected. And, with greater experience gained from continued business with the Government, should come the confidence that these unique contractual obligations which have been incurred are well-defined by a mass of Government precedent and regulation which has developed around them.

With respect to construction contracts for Federal highway projects, the construction phases of the contract must necessarily be governed by the plans and specifications developed by the engineers of the Bureau of Public Roads. However, the general contractual obligations of the contractor with respect to changes, changed conditions, termination for default, inspection, payment and disputes, as well as the many clauses required by Federal statutes, are contained in printed forms of "General Provisions" and "Labor Standards Provisions" for construction contracts which are issued by the General Services Administration for all Government agencies.<sup>5</sup> It is this portion of his contract assembly that the contractor "submits to" without argument. Aside from the clauses which are dictated by the requirements of specific Federal statutes,<sup>6</sup> the other clauses of the "General Provisions" referred to above were hammered out over a period of many years on the basis of decisions by the Federal courts and almost

<sup>2</sup>In practically every session of Congress since at least 1930, there have been legislative proposals submitted proposing some new term or condition for the advancement of a social, economic or political policy. Most fail of enactment; many do not. For example, amendments proposing the incorporation of "Buy American" requirements in the Federal Aid Highway Act of 1934 were defeated in floor debate (78 Cong.Rec. 8644). Similar proposals were advanced with the Federal Aid Highway Act of 1936, but defeated (80 Cong.Rec. 5595-96). The present session of Congress has several such bills before it; for example, the bill calling for amendment of the Davis-Bacon Act (40 U.S.C. 276a) for recognition of fringe benefits in determining prevailing wages (H.R. 6041, 88th Cong., 1st session, introduced by Mr. Roosevelt, May 6, 1963).

<sup>3</sup>The Davis-Bacon Act (40 U.S.C. 276a) is illustrative of this (see discussion at footnote 19, supra). So also is the prohibition against the use of convict labor (section 1.24(a) of the Federal Aid Highway Regulations). This requirement originated as a rider on the Department of Agriculture Appropriations Act for fiscal year 1933, (Act of July 7, 1932, 47 Stat. 609, 634) and subsequent annual appropriation acts. Later (1935), it was incorporated in the regulations applicable to the Federal-aid highway program, and is presently codified as section 114(b) of title 23, United States Code. Finally, the current section 1.24(a) has recently been held to be too broad in its prohibition (41 Comp. Gen. 213) and is presently being revised (See Public Roads Instructional Memorandum 21-7-61 of November 7, 1961).

<sup>4</sup>Miller, Arthur S. Government Contracts and Social Control: A Preliminary Inquiry. Virginia Law Review, Vol. XLI, 1955, p. 27-58.

<sup>5</sup>40 Code of Federal Regulations, 1.16.101 and 1.16.901, Standard Forms 23-A and 19-A.

<sup>6</sup>See Title 41, United States Code.

daily decisions by the Comptroller General of the United States governing the field of contract rights and procedures.<sup>7</sup>

Since this group is concerned primarily with national economic, social and political policy as they have been required by the Bureau of Public Roads in State contracts for Federal-aid highway construction, I shall refer principally to the provisions prescribed in Attachment 1 to the Bureau's PPM 40-4, dated April 24, 1962, as amended, as they implement applicable provisions of Title 23, United States Code,<sup>8</sup> and Regulations for the Administration of Federal Aid for Highways, issued by the Secretary of Commerce, as well as other pertinent Federal laws and regulations.

Since these clauses were adapted in large part from the clauses prescribed by the General Services Administration for construction contracts on Federal projects, the history of the Federal clauses will best reveal the extent to which they embody national, economic, social and political goals of the Federal Government. When we realize that the Federal Government is paying the larger portion of the cost of the Federal-aid systems, it is understandable why it has every justification to pursue its economic, social and political purposes in such highway construction and in other grant-in-aid programs.

### NATIONAL ECONOMIC OBJECTIVES

The most basic economic policy consideration in public contracts is not contained in the required provisions for Federal-aid contracts because it concerns the method of entering into the contract. I am referring to the requirement for competition contained in Section 112 of Title 23, United States Code, namely, that the contract be awarded to the lowest responsible bidder following public advertisement for bids. The standard specifications of the various states fully implement the foregoing statutory requirement as well as the more specific requirements of Section 1.15 of the Regulations for the Administration of Federal Aid for Highways.

Historically, a similar requirement has been applicable to contracts to which the Federal Government is a party since the mid-nineteenth century. As far back as 1809, a Federal statute required advertisement of public bids in connection with contracts.<sup>9</sup> The present competitive bidding requirement in Federal contracts is derived directly from the Act of March 2, 1861.<sup>10</sup> This statute was later codified as Section 3709 of the Revised Statutes.<sup>11</sup> The basic procurement requirements applicable to all Government agencies is now set forth in Title III of the Federal Property and Administrative Services Act of 1949, as amended.<sup>12</sup> The rulings of the Comptroller General

<sup>7</sup>In 1949 the Congress recognized the need for uniformity in Government contract procedures and for a central procurement agency for supplies and services and passed the Federal Property and Administrative Services Act of 1949, as amended. This statute further established the General Services Administration as the central regulatory agency for Federal procurement of supplies and services. The Federal Procurement Regulations issued by the General Services Administration prescribe standard forms to be included in Federal contract assemblies, of which the "General Provisions (Construction Contracts)" is one, and prescribe regulations for the procedural aspects of Government contracting by all Government agencies. It is under the aegis of the General Services Administration that the policies prescribed by Federal statute and executive order for Federal contracts are reduced to specific contract provisions. The Armed Services Procurement Regulations issued by the Department of Defense do the same job for procurement by the armed services.

<sup>8</sup>23 Code of Federal Regulations, 1.1 through 1.38.

<sup>9</sup>Act of March 1809, 2 Stat. 536.

<sup>10</sup>12 Stat. 220.

<sup>11</sup>41 U.S. Code 5.

<sup>12</sup>41 U.S.C. 251-260. Note that section 310 (b) of the Federal Property Act (41 U.S.C. 260 (b)) provides that "reference in any Act...except subsection (a) of this section, to the applicability of Revised Statutes, section 3709 to the procurement of property and services...shall be deemed to be a reference to section 302 (c) of this Act."



of the United States, have probably had the greatest influence over the years on the development of the foregoing Federal statutory provisions, in protecting the competitive bidding system. In fact, the Comptroller General recently held, with respect to another grant-in-aid program authorized by Section 291 of Title 42, United States Code, where the statute did not prescribe the method by which construction contracts would be awarded, but the implementing regulations required competitive bidding, that project sponsors were required to comply with the Federal competitive bidding system as interpreted by the Federal courts and accounting officers.<sup>13</sup> The legislative history of Section 112 of Title 23, United States Code, also makes it apparent that it was designed to bring the Federal-aid highway construction program under the body of rules and precedents that developed around the foregoing Federal statutes.

Although the competitive bidding requirement for Federal-aid highway contracts entered into by the states does not contain the detail as to procurement methods and advertising requirements contained in the Federal statutes and regulations, as the latter apply to Federal contracts, I would recommend a review of the Federal statutory requirements of Title III of the Federal Property Act and the regulations implementing this title, issued by the General Services Administration in its Federal Procurement Regulations,<sup>14</sup> as well as the many interpretive rulings of the Comptroller General of the United States with respect to competitive bidding. In view of the indicated legislative background of Section 112 of Title 23, United States Code, the Federal statutory provisions, regulations and rulings should be a welcome and convenient guide in interpreting this extension of Federal policy to Federal-aid contracting.

In the 1930's the economic plight of our country gave birth to the Buy-American Act.<sup>15</sup> I understand that some States have similar acts or policies. While the Buy-American Act continues to be applicable to Federal contracts, Section 1.19 of the Regulations for the Administration of Federal Aid for Highways provides:

No requirement shall be imposed and no procedure shall be enforced by any State in connection with a project which may operate... (b) to prohibit, restrict or otherwise discriminate against the use of articles or materials of foreign origin to any greater extent than is permissible under policies of the Department of Commerce as evidenced by requirements and procedures prescribed by the Administrator to carry out such policies.

A recent amendment to PPM 40-4(1), dated May 17, 1963, permits the deletion of clause (b) of Section 1.19 in the respective attachments of "Required Provisions for Federal-aid Contracts" to PPM 40-4; and gives as the reason therefor the fact that:

Neither the Department of Commerce nor the Bureau of Public Roads has at this time prescribed any policies or requirements regarding the use of materials of foreign origin in Federal-aid highway contracts. The use of such materials that meet approved specifications is subject only to State law.

Although clause (b) of Section 1.19 of the Federal-Aid Regulations relates to the Federal policy set forth in the Buy-American Act, clause (a) of the same section, prohibiting discrimination by the states against articles or materials made or produced in any other state, territory or possession of the United States, is an economic policy imposed by the Secretary of Commerce and is traceable again, in large part, to the desire to maintain a system of competitive bidding, thereby obtaining the best bargain for the Federal Government in the expenditure of Federal grant-in-aid funds.

<sup>13</sup> 37 Com. Gen. 25.

<sup>14</sup> 41 Code of Federal Regulations, part 1-2.

<sup>15</sup> Act of March 3, 1933, Title III, 47 Stat. 1520, 41 United States Code, 10a-d.

There appears to be a growing interest in some states in adoption and extension of the Buy-American policies of the Federal Government to state contracting. I commend for your reading an extensive discussion of the history and the Federal policy developments of the Buy-American Act in an article published in 1961 in the *Wisconsin Law Review*.<sup>16</sup>

Another of the economic policies of the Federal Government which the Bureau seeks to assist in its administration of highway contracts is the Federal program of encouragement to small business. Congress included in Section 304 of Title 23, United States Code, the following policy statement and provisions:

It is declared to be in the national interest to encourage and develop the actual and potential capacity of small business and to utilize this important segment of our economy to the fullest practicable extent in construction of the Federal-aid highway systems, including the Interstate System. In order to carry out that intent and encourage full and free competition, the Secretary should assist, insofar as feasible, small business enterprises in obtaining contracts in connection with the prosecution of the highway program.

The Bureau has not imposed on Federal-aid construction extensive regulatory or contract requirements with respect to small business inasmuch as experience in Federal highway construction has shown that the small business construction contractor receives a very large percentage of highway construction business, either as a subcontractor or as a prime contractor for the small segments in which highways are constructed.

The Bureau has adopted its own policies in the economic field for the primary purpose of prohibiting the restriction on competition in Federal-aid highway contracting which, as indicated previously, is one of the primary statutory and regulatory protections the Bureau feels it has in obtaining the best bargain in highway construction.

These policies are reflected in Section 1.16 of the Federal-Aid Regulations, as incorporated in Section X of the "Required Provisions for Federal-Aid Contracts," with respect to licensing and qualification of contractors, and in the provisions of Section VII of the "Required Provisions," requiring the contractor to perform with his own organization contract work amounting to not less than 50 percent of the total contract cost, excluding specialty items. The restrictions on licensing and qualification of contractors are to assure the right of any responsible and eligible construction contractor to bid on Federal-aid projects and to further assure that the proper criteria are used in licensing and qualifying such contractors under the competitive bidding system. The provisions of Section VII with respect to subletting or assigning the contract are intended to preclude the brokerage of construction work by a prime contractor, once he has been determined to be eligible for highway construction work through the elaborate process of licensing and qualification; and then to insure that, to the extent that such work may be sublet or assigned, the contracting officer has an opportunity to determine that qualified subcontractors are performing the work.

There are many other Federal laws applicable to Federal contracts which reflect national economic objectives<sup>17</sup> and which are not applicable to the Federal-aid highway construction program.

<sup>16</sup> Van Cleve, Harry R., Jr. *The Use of Federal Procurement to Achieve National Goals*, *Wisconsin Law Review*, Vol. 1961, p. 566-600, 578.

<sup>17</sup> These range from the Cargo Preference Act (68 Stat. 832 (1954), 46 U.S.C. 1241 (b)), enforcing extensive preference for U.S. flag privately owned ships, to the Preference for Certain Domestic Commodities Act, [this is the so-called Berry Amendment to successive Department of Defense Appropriation Acts, e.g., Department of Defense Appropriation Act 1960, section 623, 73 Stat. 382 (1959)], requiring provisions in Federal contracts for the procurement of domestic food, clothing, and fibers; from the Humane Slaughter Act (72 Stat. 862 (1958), 7 U.S.C. 1901-1906), which restricts Government procurement of meats to slaughterers employing humane slaughtering methods, to the Walsh-Healey Act (49 Stat. 2036 (1936), 41 U.S.C. 35-45), providing for minimum wages, maximum hours and working conditions for workers employed in the performance of Government supply contracts.



The Federal construction contract labor laws are a complex of both social and economic objectives which stem in large part from the chaotic conditions which prevailed in both these fields in the 1930's. Of course, the former Eight-Hour Law<sup>18</sup> is the oldest of these labor laws, having been first enacted with the requirement that it be included in Federal contracts. It required contractors to pay laborers and mechanics employed on Federal construction contracts time and one-half for any hours over eight a day worked under a Federal contract. It provided for both the withholding of the necessary monies to pay affected laborers and mechanics at the contractual rates, and a penalty for each such violation.

The three acts with which we are most concerned in the field of Federal-aid contracts are: (1) The Davis-Bacon Act,<sup>19</sup> which has been incorporated into the highway program for enforcement by the Bureau by Section 113 of Title 23, United States Code, (2) the Copeland "Anti-Kickback" Act<sup>20</sup> and the Work Hours Act of 1962.<sup>21</sup> These acts and the implementing regulations promulgated by the Secretary of Labor thereunder,<sup>22</sup> provide for their implementation by the incorporation of specified contract provisions in all contracts subject to the acts.

The Davis-Bacon Act is designed, in part, to preclude the utilization of the wages of laborers and mechanics as an element in the competition for public construction contracts, by requiring the payment of minimum wage rates determined by the Secretary of Labor to be prevailing in the area of the work of each classification of labor.

The Copeland "Anti-Kickback" Act provides that unauthorized deductions or the exaction of rebates from the wages paid to any person employed in the construction of public works are criminal acts. The required provisions prescribed by the Secretary of Labor under this act (Section III of Attachment 1 to PPM 40-4) require the payment of laborers and mechanics unconditionally, and not less often than once a week, without deductions or rebate on any account. As in the case of the other labor provisions, the contractor must agree to include the applicable labor provisions in all of his sub-contracts. Finally, the contract provisions required by the regulations of the Secretary of Labor under this act require the Contractor to submit weekly payrolls accompanied by a certification of compliance with the "Anti-Kickback" Act; and, in general, prescribe a minimum standard of labor relations by the contractor, insofar as his wage payment practices are concerned.

<sup>18</sup> Act of June 19, 1912, 37 Stat. 137, 40 U.S.C. 324-325a. This Eight Hour Law-movement reflects probably the earliest use of Federal contracting as a means of advancing a national socioeconomic objective. As early as the Act of June 25, 1868 (15 Stat. 77), Congress declared the national policy that eight hours should constitute a day's work for all laborers, workmen, and mechanics employed by or on behalf of the United States (R.S., section 3738). This was superseded by the Act of August 1 1892, 27 Stat. 340, 50 U.S.C. 321, which in turn has been repealed by the Work Hours Act of 1962 (P.L. 87-581, approved August 13, 1962, 76 Stat. 357, 40 U.S.C. 328-332).

<sup>19</sup> The Davis-Bacon Act, dated August 30, 1935, 49 Stat. 1011, 40 U.S.C. 276a. It is interesting to note that in the early 1930's, when the Executive Branch proposed to impose minimum wage provisions in the performance of Government contracts, the Comptroller General ruled that such provisions would be invalid (10 Comp. Gen. 294, 298). On the grounds that such provisions would increase the cost of Government contracting and the increased cost was without the sanction of any public law and therefore invalid as an improper expenditure of Government money. Concerning the extent to which section 113 of title 23, United States Code, embodies the Davis-Bacon Act, the Comptroller General has ruled that the legislative reference to the Davis-Bacon Act in section 113 of title 23, United States Code, does not result in the entire incorporation of that act (Davis-Bacon) into section 113. Specifically he has held that the mandatory debarment provisions of the Davis-Bacon Act (40 U.S.C. 276a-2) are not applicable to Interstate highway construction contracts (unpublished decision of the Comptroller General, B 144075 of October 13, 1960).

<sup>20</sup> The Copeland "Anti-Kickback" Act, Act of June 13, 1934, 48 Stat. 948.

<sup>21</sup> The Work Hours Act of 1962, P.L. 87-581, approved August 13, 1962, 76 Stat. 357, 40 U.S.C. 328-332.

<sup>22</sup> 29 Code of Federal Regulations, subtitles 3 and 5.

The Work Hours Act of 1962 established a new requirement for incorporation into the Federal-aid highway construction contract. This act requires, under a public construction contract subject to the act, the payment of time and one-half to a laborer or mechanic for all hours worked in excess of eight per day or forty per week. It repealed the old Eight-Hour Law; but, like the former law, has provisions for withholding of funds from the contractor to cover the unpaid wages of laborers and mechanics, and prescribes a penalty to be assessed against the contractor for each such violation. In addition, like the former Eight-Hour Law, an intentional violation of the law becomes a Federal misdemeanor. Like the Davis-Bacon Act, which was made applicable to the Interstate highway construction program by Section 113, Title 23, United States Code, the requirements of the Work Hours Act of 1962 are applicable only to Federal and Federal-aid construction contracts entered into in connection with the Interstate highway construction program. The Copeland "Anti-Kickback" Act, however, is applicable to all public works financed, in whole or in part, with Federal loans or grants-in-aid; and would apply to all Federal-aid programs.

I would like, particularly, to call your attention to the Labor Compliance Manuals which the Bureau has published for both direct Federal and Federal-aid contracting. These manuals set forth the Bureau's policies and procedures applicable to the labor compliance provisions required in both Federal and Federal-aid construction contracts. Some of our labor compliance officials in the field have expressed the opinion that the procedures and requirements in these manuals are to be used as guidelines for application when they deem it appropriate. It was because of this possible misconception as to the purpose of the manuals that Mr. Whitton included in his foreword a statement to the effect that the requirements of the manual are as mandatory as any regulatory provisions issuing from the Bureau. I would like you to impress upon your clients in the state highway departments the necessity for strict compliance with your Federal-aid manual on labor compliance, and the many headaches that can be avoided by making their contractors aware of these labor requirements at preconstruction conferences.

Our Labor Manuals incorporate the labor requirements, as defined in the aforementioned laws, and their implementing regulations of the Secretary of Labor. In addition, they cover the labor provisions of the Regulations for the Administration of Federal Aid for Highways. Section 1.24 of these Regulations:<sup>23</sup> (a) prohibits the use of convict labor, (b) prohibits discrimination by a state against out-of-state labor, and (c) requires the establishment of minimum wage rates in all Federal-aid construction contracts. Like the labor standards prescribed by statute there are discernible economic and social policies underlying these regulatory requirements. These standards are premised solely on the administrative authority of the Secretary of Commerce; but they originate from the express authority given the President by section 1 and 7 of the Emergency Relief Appropriation Act of 1935,<sup>24</sup> and similar authorizations and requirements contained in the Emergency Relief Appropriation Act of 1935, 49 Stat. 115 and other Relief Acts of the 1930's, such as the National Industrial Recovery Act.<sup>25</sup>

#### NATIONAL SOCIAL OBJECTIVES

Nondiscrimination in the employment of persons is an example of a national social objective enforced through Federal contracting procedures. This objective had its origin in the requirements imposed by the Federal Works Agency in the 1930's in connection with contracts let under funds appropriated under various emergency relief acts of that period. In line with such social policy the Bureau has carried into Section II of the "Required Provisions for Federal-Aid Contracts" the imposition on the contractor of the requirement that he "shall not discriminate against any worker because of race, creed, color, or national origin, nor labor from any other state, possession, or territory of the United States." The Bureau has further required, in Section V of the

<sup>23</sup> 23 Code of Federal Regulations 1.24.

<sup>24</sup> Emergency Relief Act of 1935, 49 Stat. 115.

<sup>25</sup> National Industrial Recovery Act, section 206, 48 Stat. 195, 205.



Required Provisions, appropriate statistical information necessary to provide the Government with satisfactory evidence of the effects of its contracting policies in this entire field.

The Federal requirements with regard to nondiscrimination in employment may be of interest to you in view of the pending program of the President before the Congress which may extend similar requirements to all Federal grant-in-aid programs.<sup>26</sup> The current requirements applicable to Federal contracts are contained in Executive Order No. 10925 of March 6, 1961,<sup>27</sup> as amended, and particularly in Section 303 thereof. It is interesting to note that in the Whereas clauses of Executive Order 10925, and the earlier executive orders with regard to nondiscrimination, the President declares that discrimination because of race, creed, color, or national origin is contrary to constitutional principles and policies of the United States and that it is the plain and positive obligation of the United States Government to promote and ensure equal opportunity. Regulations and instructions pursuant to this Executive Order are issued by the President's Committee on Equal Employment Opportunity; and the effectiveness of the contract requirements in Federal contracts is now being explored by this Committee through the use of prescribed reporting forms.

Although the typical Government construction contract permits termination for default by the contractor only upon refusal or failure to prosecute performance of the work, Executive Order 10925 requires Federal contracts to include the following provision:<sup>28</sup>

In the event of the Contractor's noncompliance with the Nondiscrimination clause of this contract or with any of the said rules, regulations, or orders, this contract may be canceled in whole or in part and the Contractor may be declared ineligible for further Government contracts in accordance with procedures authorized in Executive Order No. 10925 of March 6, 1961, and such other sanctions may be imposed and remedies invoked as provided in the said Executive order or by rule, regulation, or order of the President's Committee on Equal Employment Opportunity, or as otherwise provided by law.

And the Order further requires that such provision be included in all subcontracts or purchase orders issued by the prime contractor.

It seems evident that although Congress has not adopted by legislative enactment such social policies and objectives in the field of nondiscrimination as the President has prescribed, it has, over the years, acquiesced in such executive objectives as effective national policy.

<sup>26</sup> In the final point of the omnibus civil rights bill sent to Congress on June 19, 1963, the President requested that the Federal Government be authorized by Congress to deny Federal assistance "to any program or activity in which racial discrimination occurs." In his message accompanying the bill, the President stated, in part: "Instead of permitting this issue to become a political device often exploited by those opposed to social or economic progress, it would be better at this time to pass a single comprehensive provision making it clear that the Federal Government is not required, under any statute, to furnish any kind of financial assistance—by way of grant, loan, contract, guaranty, insurance or otherwise—to any program or activity in which racial discrimination occurs. This would not permit the Federal Government to cut off all Federal aid of all kinds as a means of punishing an area for the discrimination occurring therein—but it would clarify the authority of any administrator with respect to Federal funds or financial assistance and discriminatory practices."

<sup>27</sup> 3 Code of Federal Regulations, 1961 Supplement.

<sup>28</sup> Clause 21 (f) of Standard Form 23-A, issued by the General Services Administration, and as required by section 301 of Executive Order 10925.

## NATIONAL POLITICAL OBJECTIVES

Political objectives are difficult to define as a category. They might be defined as moral objectives or, more appropriately for purposes of this discussion, collectively, as other than economic and social policy objectives. Certainly the conflict of interest requirement of Section 1.33 of the Federal-Aid Regulations which is included in Section X of the "Required Provisions for Federal-Aid Contracts" expresses a high moral standard and political policy with which no one would disagree. This same high moral standard is imposed on the contractor in requiring that he sign a noncollusion affidavit and upon all engineers, contractors, suppliers, workers and any other persons concerned with Federal highway projects in the requirements with regard to "False Statements Concerning Highway Projects," referred to in paragraph 7 of PPM 40-4 and as Section IX of the "Required Provisions." In connection with this latter requirement, the attention of all personnel involved in highway construction is invited thereto by posting at the Federal-aid highway project itself the provisions of Section 1020 of Title 18, United States Code.

It is interesting that at the Blatnik Committee hearings on Arizona repeated reference was made by members of the Committee to the provisions of Section 1020 and a surprising number of state witnesses engaged in highway construction indicated that they were unaware of their liability thereunder. This would indicate that the notices either are not being posted or are not read and fully comprehended by the construction personnel who are clearly affected thereby.

In the interest of requiring the state highway departments to tighten their controls over these aspects of highway construction and to endeavor to prevent fraud and collusion, the Bureau issued its statement of policy as to administrative action to be taken by the Federal Highway Administrator in instances of irregularities.<sup>29</sup> The purpose of this regulation is not only to protect the Federal dollar but also to insure protection of the public right of confidence in the trustworthiness of all personnel engaged in programs in which the Federal Government participates—in this instance the performance of Federal-aid contracts in which the Federal Government has such a large financial stake.

## CONCLUSION

I hope this discussion has enlightened you, if not convinced you, as to the extent to which the contractor's submission to Federal requirements in any Federal-aid construction contract is wholly justified in terms of the overall national policy objectives that are achieved by those requirements—and for which he cannot bargain. Economic, social, and political controls such as are imposed on Federal-aid contracting obviously could not be left to the bargaining table. It is arguable that the economic coercion imposed on contractors by such Federal requirements increases the cost of construction services; but the fact is that there are many equalizing requirements, as I have indicated, which eliminate discrimination against responsible and able bidders and which are intended to and do prevent brokerage of contracts. I am sure that if you compare the costs of construction under state contracts, without the Federal requirements, and the costs of construction under Federal-aid contracts, with such requirements, you will find very little monetary difference.

In any event, the Federal statutory, regulatory and policy requirements are here to stay and we are asking that legal representatives of state governments enforce the spirit and not just the letter of such policies. If you recognize these facts to be self-evident and help us in the Bureau to enforce these policies, I am sure that many of the situations that have been presently focusing attention on the detrimental aspects of the highway construction program could be avoided.

<sup>29</sup> 23 Code of Federal Regulations, Part 2, see Federal Register, August 23, 1962, 27 F.R. 8448.

# Antidiscrimination Provisions of Highway Contracts

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•THIS paper discusses the antidiscrimination provisions of highway contracts, particularly as to the Federal-aid highway programs. I fully recognize the sensitivity of the subject and shall be objective in commenting upon the background and some of the aspects of the present Federal requirements—as may be of interest to state legal officers. The importance of the President's Equal Employment Opportunity Program cannot be overemphasized.

My remarks are being confined primarily to Executive Order 11114, and the implementing regulations of the President's Committee on Equal Employment Opportunity, which are applicable to Federal-aid highway work. I believe it would be an understatement to say that there has been no little confusion and apprehension in the minds of many concerning some aspects of these requirements.

Executive Order 11114, signed by the President on June 22, 1963, and the implementing regulations which became effective on September 7, 1963, are designed to extend governmentwide, to all federally assisted activities, the basic principles of the nondiscrimination program that were made applicable to direct Federal contracts under prior Executive Order 10925 by the President on March 6, 1961.

This program is carried out under the overall direction of the President's Committee on Equal Employment Opportunity on which President Johnson served as Chairman for almost three years. Its membership includes certain Cabinet members, including the Secretary of Commerce, and many prominent officials embracing a broad spectrum of public and private life.

By way of background, I might say that the subject is not new to the Bureau of Public Roads inasmuch as the Bureau has for many years required a nondiscrimination clause in the special provisions for all Federal-aid construction projects. Nor is the subject new at the Federal level generally, for there have been Executive Orders applicable to Federal contracts for more than 20 years, dating back to Executive Order 8802 issued by President Roosevelt on June 25, 1941. The following Executive Orders have been issued on the subject:

Executive Order	Date
8802	6-25-41
9001	12-27-41
9046	5-27-43
10308	12- 3-51
10479	10-13-53
10557	9- 3-54
10925	3- 6-61
11114	6-22-63

I feel sure you are generally familiar with the objectives of the Executive Order 11114. It recites that it is a requirement of the United States Government that affirma-

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tive action be taken to provide for the elimination of discrimination because of race, creed, color, or national origin in employment on work involving Federal financial assistance, to the end that employment opportunities created by Federal funds shall be equally available to all qualified persons. The underlying concept is that no qualified person should be denied a job or equal treatment because of these possible discriminating factors.

As there may have been but relatively few problems in this field coming to the Bureau's attention over prior years, and some may also contend that the highway industry basically has been following a policy of nondiscrimination, the question may well arise as to the need for the present requirements and enforcement provisions which, to be sure, are much more strict than heretofore. In response, it should be stated that the problem is considered national in scope and is not centered in any particular industry, and that it was felt desirable by the President that more enforceable affirmative steps be taken to give adequate assurance that all programs financed in whole or in part with Federal funds are in compliance.

In this connection, an official of the Department of Labor has recently made the following statement:<sup>1</sup>

During 1963, pursuant to a directive of President Kennedy, the Department of Labor made a survey of Federal construction projects to determine whether there was discrimination on those projects in connection with the hiring of journeymen or the selection of apprentices. Site surveys of 47 major projects in as many different cities were made. These surveys showed that, at the time of our inspection, 7,795 construction workers were employed on the projects which were surveyed. Of these, 1,389 were Negroes. All but 316 of these Negroes were employed in the unskilled category of laborers. Among the skilled journeymen, there were only 300 Negroes, compared to 5,658 whites. In a majority of the skilled crafts there were no Negroes. Of 319 apprentices, only 16 were Negroes.

These figures confirm the fact that a situation exists in the construction industry which has to be followed up aggressively on a case-by-case basis. They show a wide variety of practices, varying from project to project and among the different building trades. It is clear that the problem is not a sectional one, but is national in scope.

Some, I know, have questioned the legality of the Executive Order and regulations as applied to Federal-aid highway activities. The Department of Justice and the courts, of course, rather than the Bureau of Public Roads are the final judges. I should mention, however, that shortly after the issuance of Executive Order 10925 in 1961 as applied to direct Federal contracts, the Department of Justice rendered an opinion upholding its validity. Up to this time, we are not aware that the President's authority to require a nondiscrimination clause has been litigated in the courts.

Attention is invited, however, to a recent significant case in Federal court, prior to the issuance of Executive Order 11114 for Federally assisted programs. *Simkins v. Moses H. Cone Memorial Hospital*, 323 F.2d 959 (argued April 1, 1963; decided November 1, 1963). Certiorari denied, 32 L.W. 3303.

This was an action by Negro physicians, dentists and patients suing on behalf of themselves and other Negro citizens for declaratory and injunctive relief against defendant hospitals and their administrators and directors for discrimination because of their race. The United States District Court for the Middle District of North Carolina entered judgment adverse to plaintiffs and they appealed. The Court of Appeals, 4th Circuit, held that portion of the Hill-Burton Hospital Survey and Construction Act tolerating "separate-but-equal" facilities for separate population groups and relevant reg-

<sup>1</sup>Statement of Kenneth C. Robertson, Deputy Solicitor of Labor, before the Kentucky Association of Highway Contractors, Hollywood, Florida, January 27, 1964.

ulations implementing that passage in statute are unconstitutional under the due process clause of the Fifth Amendment and the equal protection clause of the Fourteenth Amendment and that plaintiffs were entitled to relief. The court also held, in effect, that private hospitals which participated in the Hill-Burton joint Federal and State program for allocating aid to hospital facilities were sufficiently involved with State, including Federal, action to be within Fifth and Fourteenth Amendment prohibitions against racial discrimination.

In the above case, the court stated, in part:

Here the most significant contacts compel the conclusion that the necessary "degree of state [in the broad sense, including federal] participation and involvement" is present as a result of the participation by the defendants in the Hill-Burton program. The massive use of public funds and extensive state-federal sharing in the common plan are all relevant factors. We deal here with the appropriation of millions of dollars of public monies pursuant to comprehensive governmental plans. But we emphasize that this is not merely a controversy over a sum of money. Viewed from the plaintiffs' standpoint it is an effort by a group of citizens to escape the consequences of discrimination in a concern touching health and life itself. As the case affects the defendants it raises the question of whether they may escape constitutional responsibilities for the equal treatment of citizens, arising from participation in a joint federal and state program allocating aid to hospital facilities throughout the state.

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Our concern is with the Hill-Burton program, and examination of its functioning leads to the conclusion that we have state action here.

Attention is also invited to another recent case in Federal court, *Farmer v. Philadelphia Electric Co.*, 215 F Supp. 729 (1963), affirmed by Court of Appeals, 3d Circuit, March 12, 1964, 31 L.W. 2500. In this case, an employee of a contractor having a Federal contract containing a nondiscrimination clause under an earlier Executive Order 10557 was seeking, as a third party beneficiary, damages from the contractor on grounds of violation of the clause. The United States District Court, in denying the claim, held that the Executive Order did not create a private right of action against contractors. In the affirming decision, the Circuit Court of Appeals stated in part:

The doctrine of "exhaustion of administrative remedies" should at least be applied here, and the employee should be required to file a complaint with an appropriate contracting agency or with the President's Committee before being permitted to seek the aid of a federal district court. However, whether a district court could then entertain jurisdiction is not here decided.

The court also went on to say—

As far as we have been able to ascertain, the Department of Justice has not instituted any proceeding in any court against any non-complying contractor to enforce the nondiscrimination provisions of a Government contract.

The history of the orders, the rules and regulations made pursuant to them, and the actual practice in the enforcement of the nondiscrimination provisions are all strong persuasive evidence, it seems to us, that court action as a remedy was to be used only as a last resort, and that the threat of a private civil action to deter contractors from failing to comply with the provisions was not contemplated by the orders.

Some may contend that a distinction exists between Federal contracts having non-discrimination clauses, wherein the United States sets the terms and conditions on which it does business with contractors, and state contracts under Federal assistance



programs, in which latter case the Federal Government is not in privity with the contractors. However, such contentions cannot be dismissed without recognizing that nondiscrimination clauses, whether in Federal or Federal-aid work, involve consideration of constitutional principles, including the authority of the Chief Executive to carry out, as a condition to any expenditure or grant of Federal funds, a longstanding public policy of the United States. In the case of *Hirabayashi v. United States*, 320 U.S. 81, p. 100 (1943), Chief Justice Stone of the United States Supreme Court stated: "Distinctions between citizens solely because of their ancestry are by their very nature odious to a free people whose institutions are founded upon the doctrine of equality."

Upon the issuance of Executive Order 11114, the Federal Highway Administrator delegated to the General Counsel of the Bureau the responsibility for preparing the necessary implementations to comply with the order and regulations, and Instructional Memorandum 20-2-63 of September 10, 1963, sets forth the clauses and requirements applicable to the states and contractors. The Bureau has no authority to waive the requirements as are necessary to comply with the Executive Order or the Regulations of the President's Committee. In view of the compliance aspects of the program, the Office of Audits and Investigations of the Bureau has recently been given the responsibility for administering the compliance and operational phases of the program, and a Contracts Compliance Officer has been designated in that office to handle this activity. The General Counsel's office, however, will continue to render advice and assistance on any legal problems which may arise.

Recognizing the cooperative Federal-state arrangement on highway work which is undertaken under state contracts, I appreciate the concern that may prevail as to the possible impact of the enforcement and sanctions provisions. Section 60-1.5 of the regulations vests in the administering agency, namely the Bureau of Public Roads, the primary responsibility for obtaining compliance with the equal opportunity clause. On the other hand, section 60-1.3 places certain responsibilities on the state, namely, to agree to include the required clauses in all contracts for Federal-aid construction, to agree to certain other clauses, including the requirement "to cooperate actively," and to otherwise assist the Bureau in the discharge of its primary responsibility.

The state must also agree to refrain from entering into any contract with a debarred contractor and that it will carry out sanctions and penalties imposed by the Bureau or the President's Committee. Further, the state must agree that if it fails to comply with these undertakings the Bureau may cancel, terminate, or suspend the Federal-aid grant in whole or in part, and may withhold further assistance until satisfactory assurance of future compliance has been received, or may refer the case to the Department of Justice for appropriate legal proceedings. Some may say that these requirements may result in possible litigation, cancellations, or suspension of Federal aid, and many other serious problems affecting the Federal-state-contractor relationships.

These provisions were apparently patterned after the language contained in the earlier Executive Order and regulations for direct Federal contracts. The language is tough and a state's possible concern is understandable, as the possible sanctions may be considered like the sword of Damocles. On the other hand, it should again be emphasized that these requirements were prescribed by the President's Committee as enforcement rather than punitive measures. In actual operation and based on previous experience, it is expected that compliance can be achieved without resorting to the application of these sanctions. It is understood that in no instance have any Federal contracts been cancelled under the authority contained in the earlier Executive Order 10925 issued in 1961 for all Federal contracts. Every problem which has arisen so far has been resolved through voluntary compliance. Of course, it must be understood that the Government is prepared to take additional action if necessary.

In this connection, it should be noted that the Executive Order and regulations contemplate compliance "by informal means whenever possible," and through "conference, conciliation, mediation, and persuasion" (E.O. 10925, sec. 312f; 41 CFR 60-124(b)(2)). Such informal procedures, and the knowledge that a contractor may be declared ineligible for future work if he does not comply would seem to provide the most effective approach and reasonable assurance toward obtaining compliance without the use of sanctions. Furthermore, there is the opportunity for hearings, should the informal process fail.



I might briefly comment that the President's Committee has not yet adopted and issued compliance forms to be executed by contractors for Federal-aid work. The Committee is in the process of preparing a compliance manual for field investigations. This should give both the Bureau and state personnel a better understanding of the manner in which investigations and compliance matters will be handled. It is understood that every effort is being made by the Committee to simplify procedures to the extent possible. In the meantime, complaints and compliance problems will be handled on a case-by-case basis.

It may be of interest to mention that, as of February 1, 1964, 141 corporations employing approximately 7 million workers had signed a "Plans for Progress" program, sponsored by the President, under which they have voluntarily pledged themselves to promote equality of employment opportunity—without regard to or even mention of the extent of their Government obligations, if any, to take such action. This "Plans for Progress" program reflects the desire of both Government and industry to accomplish the objectives set out in the equal opportunity clauses—objectives which can be more readily obtained by cooperation than by compulsion.

Further, there is a "Unions for Fair Practices" program in which 117 of the international AFL-CIO unions have pledged to take affirmative action to end any discrimination in their ranks.

Recently, the President has met with labor leaders at the White House and created a Labor Advisory Council which is designed to provide a more effective and fruitful relationship between the President's Committee and the AFL-CIO.

The importance of the equal employment opportunity program is reflected in President Johnson's recent message on the state of the Union, in which he said:

Let me make one principle of this Administration abundantly clear: All of these increased opportunities—in employment, education, housing and every field—must be open to Americans of every color.

As far as the writ of Federal law will run, we must abolish not some but all racial discrimination.

As recently stated by the President, it is appropriate to inquire "What skills do you have and what qualifications do you possess?" but it is never fair to inquire as to a person's color or religion.

In closing, may I say that, from both the legal and administrative aspects, the subject of nondiscrimination involves many complexities and problems. But regardless of laws, regulations, and issues of states' rights and civil rights, there is every reasonable hope we can attain this goal with a minimum of confusion and conflict by use of the constructive approach and the informal means and processes which are provided for, if problems are encountered. No law, regulations, or procedures are effective unless accompanied with knowledge and understanding. As someone once said:

Goodness without knowledge is weak and feeble, yet knowledge without goodness is dangerous. Both united form the noblest character and lay the surest foundation of usefulness to mankind.

In the spirit of this message, the Bureau of Public Roads will continue to cooperate actively with the President's Committee, just as the state highway departments are expected to extend their cooperation in this program.

# Pre-Bidding Measures To Minimize Controversies in Highway Construction

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•THE large volume of highway construction being performed throughout the country has led to an ever-increasing volume of litigation in connection with public improvement contracts. While much of this litigation concerns disputes arising out of the government's administration of these contracts, a substantial portion of this litigation is the result of certain inappropriate attitudes and methods employed by the government in the pre-bidding or letting stage of the contract. It is, as I shall attempt to illustrate, the prevalence of these inappropriate attitudes and methods that has made competitive bidding in public improvement work a much more hazardous and risky business than it was intended to be—or should be. Let us briefly examine the standard public improvement contract that is let by the Department of Public Works of the State of New York, which, in all likelihood, is similar to such contracts let by other states.

## THE CONTRACT

The contract contains a multitude of items of work to be bid at unit prices with a sprinkling of a few lump sum items. The estimated quantity of each unit item is specified.

The contract also contains a number of so-called exculpatory clauses (about which we shall have more to say later), a completion date, often some special specifications as distinguished from the general specifications adopted by the State Department of Public Works and an estimate of the cost of the entire work which sets the maximum of any bid.

Two things are noteworthy. First, the proposal, containing the contract, plans and specifications are prepared and priced by the State. Second, the proposal cannot, in any respect, be altered, changed or modified by a bidder prior to the letting of the contract.

Thus, the public improvement contract is not the result of the usual bargain and exchange of two contracting parties. The language is solely that of the State. The bidder cannot insert clarifying clauses, nor eliminate inappropriate, ambiguous or inequitable provisions nor in any way modify some of its wording.

A New York State Court has held:

The State is called upon, in contracting with its citizens, to set a standard which for fairness, justice, equity, honest and plain, frank statement of its purpose, without subterfuge or circumlocution, shall be beyond all criticism as being in any way possible of deception.<sup>1</sup>

We believe our discussion will demonstrate that the standard contract and the State's pre-bidding practices fall far short of meeting the precepts set forth in *Atlanta Const. Co. v. State*.

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<sup>1</sup>Atlanta Const. Co. v. State, 103 Misc. 233, 236.

It is obvious that the contractor, in submitting his bid, is restricted not only by the State's design, the State's quantities and the State's conditions of work, but also by the State's concept of cost. Accordingly, it is in this context that the relationship of the contractor and the State must be viewed in any discussion of pre-bidding practices.

Let us take a closer look at some of the State's pre-bidding practices and procedures which constantly lead to controversy and litigation. Let us also see how these practices and procedures can be modified or altered to reduce the incidences of controversy and litigation and make competitive bidding a competition of excellence rather than a contest of speculation.

### SUBSURFACE CONDITIONS

The single most grievous fault that the State may be charged with is the manner in which it obtains its subsurface information and the procedure it utilizes in making this information known to the contractor. The State generally restricts its major subsurface investigations to the immediate vicinity of walls and bridges, with little, if any, subsurface investigation elsewhere in the contract site.

This preoccupation with detailed subsurface conditions at structures and very limited investigation elsewhere has consistently plagued contractors seeking to make an intelligent bid. Although the State makes limited subsurface investigations other than at structures, it nevertheless purports to represent the subsurface conditions in its design of embankments, water lines and sewers.

The State represents its concept of subsurface conditions in still other important ways—in its statement of the quantities of general and trench excavation and in its earthwork tables which purport to show the amount of suitable excavation for embankment purposes. It matters greatly to an intelligent bidder whether the work under consideration will be a "borrow" or a "surplus" job. It is also of great concern to an intelligent bidder whether or not he will encounter suitable or unsuitable material and whether or not he will be excavating rock or earth. Although these subsurface conditions are of utmost importance and directly influence the entire cost analysis of the work, it is in just this vital area that the State introduces the surprising element of guesswork.

To make a bad situation worse, the State artfully attempts to inform the bidder as to its knowledge of the prevailing subsurface conditions at the same time as it attempts to dodge this responsibility. What are some of these attempts at broken-field running? To begin with, the State, having obtained boring data or other subsurface information, fails to include these data as a part of the contract documents. Instead, the State informs the bidder that such subsurface explorations have been made and that the bidder may see the data at the District Engineer's Office, but the State carefully avoids including this information as an express part of the contract.

The State also attempts, usually without success, to avoid the consequences of any misinformation in its data by exculpatory language in the contract to the effect that while the contractor may see this information he really should not rely on it. Indeed, the State includes in all of its contracts an admonition to the bidder that "the information obtained therefrom (the borings) is not to be substituted for personal investigation and research by the Contractor. . . ."

We do not have to point out to you that insofar as subsurface conditions are concerned, the contractor has little, if any, opportunity to make extensive subsurface investigations. The contractor has less than three weeks in the average case to prepare his bid. This is hardly sufficient time to embark upon a program of subsurface exploration. Particularly is this true when you contrast the contractor's brief period with the years that the State has taken to design the job.

It is also most unbecoming for the State to provide that the contractor should make his own investigations when the State knows that it would not only be impractical from an economic standpoint but that the contractor would not, in most instances, be permitted to come onto a proposed work site for such investigations. Can you imagine eight contracting companies taking pre-bidding borings in major urban and suburban areas in New York?

The State's failure to take a sufficient and complete sampling of subsurface conditions throughout the site and the State's attempt to avoid the consequences of its acts have created a serious bidding problem. On the one hand, the contractor is constrained to rely on the State's design and other subsurface representations, and at the same time, is faced with the State's disclaimer of all responsibility as to the sufficiency of its design and the reliability of its subsurface information. The normal risks inherent in bidding public improvement work is thus made more hazardous and results not only in higher costs but in expensive litigation.

Let me give you a few examples of the harm that can be created by these practices.

In one expressway project constructed by the State in New York City, virtually every contractor has made a claim for additional costs resulting in whole or in substantial part from the State's failure to have obtained proper subsurface information. In several of these cases, testimony revealed that every retaining wall flanking both sides of the expressway for thousands of feet had to be revised and redesigned because of subsurface conditions. Also, apartment houses, schools, and churches abutting the deep expressway cuts either had to be underpinned or in other ways specially protected. All of this additional work was required to be planned and designed after the onset of actual construction. In one notable instance, the State determined during construction that a six-story, fully occupied apartment house had to be acquired and demolished because of the poor subsurface conditions. Over one year of the contract term was consumed before this removal was accomplished.

During the trial of these claims, it was acknowledged by the State that there were insufficient borings or other subsurface explorations in the vicinity of the problem areas. Would it not have been far better for both the State and the contractor had sufficient borings been taken and the work properly designed before the onset of construction rather than during construction?

Another case, involving the construction of a portion of the Long Island Expressway, points up the tremendous additional costs that can result from the State's failure to obtain sufficient subsurface information.

The contractor was required to construct a 48-inch sewer in a service road on each side of the expressway. Each sewer was approximately one mile long and from 18 to 32 feet deep. During the course of excavating the trenches for these sewers, it was discovered that over 90 percent of the excavated material was unsuitable for backfill. The material consisted of large blocks of concrete (placed there after demolition of the 1939 World's Fair), garbage, muck, etc.

These subsurface conditions required that the amount of temporary sheeting be doubled, that the type of equipment be changed from dragline to crane and bucket, and that the daily quantity of trench excavation be reduced to one-fourth of the planned production.

The proof at trial showed that the additional costs of excavation and replacement of the unsuitable material was over one and one-half million dollars. Furthermore, the extended time of performing the trench excavation affected every other important item of the work and delayed completion of the contract by over two years.

At the conclusion of said case, the contractor received the highest award ever rendered in the State of New York in litigation of this kind. Clearly, this is a prime example of the damage a public authority does to itself with a short-sighted policy with respect to subsurface investigations. Nevertheless, even Court awards are no substitute for proper and fair bidding practices.

The Court of Claims of the State of New York, before whom breach of contract cases against the State of New York are tried, is most aware of this and other State practices and has commented about them.

Former Presiding Judge John Gualtieri, writing in *John Arborio, Inc. v. State*,<sup>2</sup> referred to this problem when he wrote:

The State knew that no prospective bidder could in the space of time allotted discover the inaccuracy of its representations as to quantities when it itself

<sup>2</sup>245 N.Y.S.2d 274 (1963).



had a long period of time in which to carefully and scientifically discover the true facts.

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Unless a party to a contract such as this is held to a reasonable adherence to representations made in a contract, it would be far better to omit projected amounts altogether and inform the bidder that he must engage in a guessing game of his own rather than give him presumably carefully made guide posts which turn out in effect to be an entrapment. Justice requires that such a result cannot be tolerated and that the State because of its reckless representations, though not fraudulent, must respond in damages.

Judge Alexander Del Giorno, one of the leading and most knowledgeable jurists in this field, observed in *Lizza & Sons, Inc.*:<sup>3</sup>

While the State is not an insurer of the subsoil, its findings represent a warranty that only the approximate amount of the specified unsuitable material is to be found. The State having limited itself to bore the subsoil only in one location, it is to be expected that except for reasonable variations in the quantity specified the contractor is assured that unsuitable material would be found only at the location indicated by the borings. Unsuitable material was found in 9 locations to the extent of 89,000 additional cubic yards. The contractor could not be expected to discover this condition for itself. The condition being unanticipated and the State having had the benefits of the contractor's extra work, the State is liable therefor . . . .

The remedy for this important problem is actually quite simple. The State must, and should, make adequate subsurface explorations throughout the contract site instead of just at limited portions of the site. The information should be published as part of the contract documents so that every bidder has the same information when contemplating a bid. Finally, the State should fairly and honestly make representations upon which a contractor can rely and should delete from its contract its various exculpatory clauses attempting to evade its responsibility.

#### THE ITEM OF UNCLASSIFIED EXCAVATION

Let me turn now to a second problem which is really not far removed from the area we have been discussing. This problem concerns the State's use of an unclassified excavation item in all State contracts. The purport of this item, as you know, is that all excavation, whether earth or rock, or both, must be bid at one price. Clearly, the costs of earth excavation and of rock excavation vary substantially. Because of this great variation in cost, the contractor is compelled to guess at the number of yards of earth and the number of yards of rock that he will be required to excavate and to come up with a balanced price for doing both types of excavation.

We believe that this requirement, and the concept of one price for unclassified excavation, is manifestly unfair, unrealistic and unnecessary. Why should any bidder have to present a balanced price for performing both types of excavation when he can simply state his price separately for rock excavation and for earth excavation and be paid fairly for doing this work?

To illustrate the unfairness of this practice: A client of ours contracted to construct a portion of the New York State Thruway, which was the approach to the Tappan Zee Bridge, in Tarrytown. A part of the job site consisted of a hill known as Summit

<sup>3</sup>Claim No. 37853, affirmed 254 N.Y.S.2d 90.

Hill, which was approximately 1,100 feet long and 70 feet high at its apex. A boring had been taken at the north toe of slope and one at the south toe of slope. At each boring location rock was found about 30 feet above the subgrade of the Expressway. Thus, the contract plans showed an assumed rock line running horizontally for 1,100 feet some 30 feet above the Expressway subgrade. The State has estimated that in that area approximately 262,000 cubic yards of excavation would be required, consisting of 139,000 cubic yards of earth and 123,000 cubic yards of rock.

While the contractor was excavating said hill, rock was found about 50 feet above the Expressway subgrade at the center of the hill. Had a boring been taken at that area, as one should have been, the assumed rock line would have appeared on the contract plans as an isosceles triangle instead of a horizontal line.

The actual excavation turned out to be approximately 64,000 cubic yards of earth and 198,000 cubic yards of rock. The overrun of 75,000 cubic yards of rock in this one area resulted in a very substantial additional expense to the contractor and a claim therefor against the Thruway Authority.

Clearly, taking borings 1,100 feet apart in that type of location was insufficient. Had one intermediate boring been taken, the actual rock condition would have been revealed and litigation avoided.

The present system of unclassified excavation of necessity leads to improper bids, numerous disputes and costly litigation. This is particularly so because of the State's practice of giving to the contractor only fragmentary information concerning the anticipated quantities of rock and earth to be encountered.

This important information, usually set forth in earthwork sheets, is not made a part of the contract documents and is generally given to the contractor only upon request. Furthermore, the contractor is advised that he cannot rely on this information in preparing his bid. Once again, the contractor is faced with the unreasonable disadvantage of having to base an important part of his bid upon information that the State suggests may be unreliable.

There are sufficient risks that a contractor must undertake in a public improvement contract, without the added risk of guessing which way rock and earth quantities are going to develop. We believe that the State would also benefit by a change in the unclassified excavation concept by the elimination of unbalanced bidding on this important item of work.

It would also appear to be in the State's interest to avoid the two extreme situations that unclassified excavation invites: the large cost it incurs when a contractor guesses right, and the economic destruction of a contractor when he guesses wrong. It certainly is not to the State's advantage that a contractor should incur financial difficulties—either in respect to the job at hand or with regard to future work.

The remedy here, which will not only encourage proper bidding practices but will more fairly represent the cost of work actually performed, is to provide for separate unit items for rock excavation and for earth excavation in both general excavation as well as trench, bridge and culvert excavation.

#### THE CHANGED CONDITIONS PROVISION

Another change in State practices, which is long overdue, is the adoption of the changed conditions clause. As you know, the changed conditions concept permits the government and the contractor to negotiate an equitable adjustment whenever unanticipated subsurface conditions occur during the course of the work. This concept is particularly effective in handling overruns and underruns which exceed normal limits.

Although this provision is contained in most Federal contracts and contracts let by only one of the many departments of the City of New York, no similar provision is contained in New York State contracts. Patently, the adoption of a changed conditions clause would go a long way in encouraging better bidding practices.

Nor is such a clause a "one-way street" benefiting the contractor alone, as some public authorities insist. The State, as the Federal Government in the past, has the advantage of recourse to this provision when conditions occurring during the performance of the job so warrant.



The most salutary effect of a changed conditions clause lies in the relaxation of the outdated belief that the letting of a public improvement contract is somehow a battle of wits between the State and prospective bidders. It also provides a proper atmosphere for the handling of problems which arise as the result of unanticipated job conditions without the fault of either party.

From what I have already stated, you can see that although I have been involved in contract litigation and disputes for over thirty-five years, I firmly believe that all possible methods of avoiding costly litigation are essential and proper. This can only occur when an element of fairness and equity is introduced into the contractual relationship.

#### AVAILABILITY OF THE JOB SITE

Another area in the contractual relationship of the parties that directly influences bidding practices concerns the general area of unreasonable delay and exculpatory provisions.

A public improvement contract is let with a stated contract period and an express completion date. In formulating a bid, a contractor must calculate a number of indirect costs—such as supervision costs, field expenses, cost of general purpose equipment, and holiday time for labor. Also, a contractor has to predicate his bid on some expectancy of production and directly compute his cost of labor and equipment. Obviously, the anticipated term or duration of the contract has a bearing on both the indirect and direct costs of doing the work.

Thus the phrase "time is of the essence" has meaning not only to the letting authority who desires the completion of a job but also to the contractor who must calculate his costs on a time and efficiency basis.

All who have been engaged in the construction industry have been shocked by the ever-increasing incidences of unreasonable delay that have caused many projects to be years behind schedule. Paramount as a cause of unreasonable delay has been and is the government's failure to provide the contractor with a free work site.

Of all the numerous things that can delay a job, it is surprising that the "lack of site" is one of the most common occurrences. Insufficient lead time in acquiring property on the site is the basic fault.

We have also observed that there appears to be little direct communication between the bureau of the Department of Public Works that handles property acquisition and the bureaus of the same department that establish letting dates and contract periods. Too often the desire to construct a roadway by a certain date takes precedence over the Department's ability to obtain the work site. Better coordination at this level is imperative.

We have also observed that there is much confusion among public officials as to what, from a contractor's viewpoint, constitutes a clear work site. Public officials tend to view what is actually a restricted site as being unrestricted because of the presence of some available areas in which work can be performed. It is not sufficient to give a contractor only a portion of the site, particularly in those cases where the work involved must be performed in a number of stages. To operate efficiently, a contractor must have substantially the entire site.

Thus far, the State has responded to the problem of site interferences by the ever-increasing use of exculpatory clauses in the contract which actually accomplishes very little. The purport of these clauses is to charge a contractor with knowledge that he will not have a clear site, that he knows that there will be utility work, and that he has taken these factors into account in fashioning his bid. They also attempt to provide that the contractor, if delayed or interfered with, will have no claim for damages but will be compensated by an extension of time to do the work he was prevented from doing during the initial contract period.

This approach to problems involving a free work site is completely unsatisfactory. How, in reality, can a contractor reflect in his bid a condition which might or might not occur, where the duration of this condition and the impact on his work are completely unknown? How, in other words, does he provide a cost factor for the unknown?

The answer, of course, is that there is no practical way of establishing an intelligent cost factor for such unknown conditions. Indeed, in examination of State personnel who make up the engineers' preliminary estimates, we have attempted to find out what cost factors they use. We have discovered that they have no better way of establishing costs than do contractors, and in fact, do not include in their preliminary estimate of the work any additional costs for unknown conditions.

There are numerous recurring instances of site interferences. Only a few need be mentioned here.

In one expressway construction requiring the relocation of existing streets and the closing of other streets, the contractor discovered that the State had not vested title to any of the properties abutting these streets. Until the buildings were vacated and the properties turned over to the contractor, not only could the contractor not perform work in the area, but he was compelled to maintain access to the properties.

Another common situation resulting from the State's failure to acquire the site is the presence of occupied buildings in cut and fill sections. Obviously, a contractor's entire embankment operation is affected if he cannot make his cuts in a normal sequence or is deprived of areas to make his fills.

The following portion of a letter from a District Engineer to the Director of the Bureau of Rights of Way and Claims<sup>4</sup> aptly summarizes this problem:

. . . [T]he situation on this project is a perfect example of what can easily happen on any project where there are a large number of occupied buildings on the rights-of-way, and no prior arrangements have been made with the property owners, regarding adjustment of their claims and the manner of clearing the buildings from the rights-of-way is unsettled. To avoid such complications, it appears that rights-of-way negotiations should be undertaken many months in advance of the advertising of contracts for projects involving many buildings; particularly occupied residences. (Emphasis supplied.)

Another type of site interference results from the presence on the site of public utility companies performing relocation work. In contract after contract, particularly in heavily populated urban areas, we learned that the State had made no provision either in respect to the contract period or in its design of the work, to take into account the relocation work required of the utility companies. Indeed, most State officials that I have spoken to or examined acknowledge that the District Engineer's Office does not have a clear idea of the extent of utility work to be performed on the jobsite until after the contract letting. Most such disclosures seem to occur at the first preconstruction conference held at the District Engineer's Office.

As for the use of an extension of time to compensate a contractor for delay, this is again but an exercise in semantics. One does not compensate a contractor for his extra costs by such extension; it only increases his general costs.

Of course, the Courts have faced these problems and, with customary realism have determined that exculpatory clauses will not excuse unreasonable conduct by the State or active interferences with a contractor's performance.<sup>5</sup> It is our belief that these problems can be solved more directly and without extensive litigation.

Proper coordination of acquisition of buildings on the job site with contract lettings will tend to alleviate site obstructions. Better coordination with utility companies before the letting, with detailed information in the contract documents, will tend to alleviate site obstructions by utility companies.

<sup>4</sup>Quoted in *Grandview Const. Corp. v. State*, 204 Misc. 389,391.

<sup>5</sup>See for example *Norman Company v. County of Nassau*, 278 N.Y.S.2d 719 (Second Department, April 1967); *Ippalito-Lutz Inc. v. Cohoes Housing Authority*, 254 N.Y.S.2d 783 (Third Department, December 1964); *American Bridge Co. Inc. v. State* 283 N.Y.S. 577 (Third Department, 1935); *Wright & Kremers v. State*, 263, N.Y. 615.



### SUMMARY

We recommend that the following steps be taken to minimize controversies and litigation in highway construction:

1. A fairer and more equitable contract should be tendered to the contractor. Towards this end, the boring information and the work-up data should be made part of the contract and the exculpatory clauses deleted therefrom.
2. An intensive investigation should be made of the subsurface conditions prior to the letting of the contract.
3. The design, plans and specifications should be prepared with greater care.
4. The job site should be substantially clear of buildings and other obstructions prior to the letting of the contract.
5. A changed conditions clause should be included in the contract.
6. The excavation of rock and earth should be priced separately.

Adoption of most of the foregoing recommendations will result in transforming the bidding of a highway contract from a contest in speculation to one in efficiency.

# Settlement Procedures: Highway Contractors' Claims

DOWELL H. ANDERS, Chief Counsel, Office of the Chief Counsel, Federal Highway Administration

•IF you think I have a different perspective today on the settlement of highway contractors' claims than I did when I was Chief Attorney for the Arkansas State Highway Department, you are right. In the old days the engineers of the highway department would indulge me by discussing with me a few of the more difficult claims which they were trying to settle with the "hard-nosed" Bureau of Public Roads division engineer for Arkansas. Now that I am on the other side of the fence I am beginning to understand why the Bureau of Public Roads took its so-called "arbitrary" attitude on settlement of Federal-aid highway claims; and I hope at the end of my talk that you too will understand better some of our mutual problems.

The role of the Federal Highway Administration should be one, not of direct participation in state decisions affecting Federal-aid reimbursement, but rather one of review and either approval or disapproval of a state decision. However, I would like to stress throughout my discussion that the key to a successful Federal-state relationship is understanding and cooperation. The states and the Administration, as partners, must make every effort to understand the policies and laws under which the other must operate. Understanding is not concomitant with unreserved agreement that these are the best policies and laws. However, there must be compliance with the Federal law and the policies and requirements of the Administration if there is to be Federal participation in Federal-aid projects; and the Administration will certainly attempt to make its decisions compatible with the policies and laws of the state highway departments.

Since the Administration has a review authority with respect to state highway contractors' claims, I feel that my time would be spent most constructively by discussing what I feel is the state's responsibility in the resolution of construction claims. There is one clear premise from which we must proceed. We must recognize that an adjudication of claims by administrative findings by a state official (including a contracting officer), by a state contract appeals board, or by a state court may be conclusive under state law as to a dispute between the contractor and the state, with whom the contractor has privity, but it is not conclusive between the state and the Federal Highway Administration insofar as Federal-aid reimbursement is concerned. One further and basic reservation I would have to the Administration standing in the shoes of a state with regard to such adjudications, and one with which you certainly would not disagree, is that the Administration should not be liable for a claim which is attributable entirely to negligence or other culpable action on the part of the state personnel in administration of the contract.

The administration has authorized its division engineers and certain subordinate officials in the field to approve contracts for construction let by the states, to approve amendments thereto, and to concur in any change orders or other claim settlements by the states which involve additional performance and monetary obligations. In many cases, such an official, at his own discretion or pursuant to written instructions and policy and procedural memorandums, seeks the advice of the Regional Federal Highway Administrator and his staff; and the latter official may, in turn, request advice of the headquarters staff in Washington. These officials have a staff responsibility which must be maintained if the Administration is to perform its job properly.

The "legal" problems which arise in a state highway department under road construction contracts seldom involve only legal questions; they invariably also involve factual data and engineering decisions. This is why we, in the General Counsel's office, receive the mixed questions of law and engineering through the same channels of division engineer, Regional Federal Highway Administrator and Office of Engineering and Operations in Washington. Then the respective offices may apply their engineering judgment and evaluation to the problems.

Now, as to how to settle claims, let me recommend our procedures with respect to direct Federal contracts. The greater number of claims arise under Federal construction projects as a result of changes made in the course of the work which entitle the contractor to an equitable dollar adjustment and/or an extension of time. Our large dollar claims arise under the changed conditions clause of the Government contract terms. Since our Government contract clauses permit equitable adjustment, we encourage our engineers on the project to try to reach a settlement with the contractor, incorporate it in a change order and obtain the contractor's agreement thereto.

Our experience has been that both the contractor and the Government are never in a better position to make a decision on a claim or to further explore the facts necessary for settlement than they are at the time the situation occurs which is the basis of the claim. However, human nature being what it is, when it comes to the matter of settling the dollar value of the change or the appropriate extension of time, we succumb too often to the temptation to let the contracting officer and the lawyers argue it out with the contractor after the job is completed.

We also have the more serious problem of oral directions by the engineer to change the work, which are not converted to written orders. These are recognized by the Federal appeal boards and courts as constructive changes for which the contractor is entitled to relief.

Sometimes a project engineer cannot obtain a settlement agreement from the contractor on a written change order. Or a contractor's claim may be in the nature of a changed condition which requires extensive development of geological information and the application of case law. In these instances, we ask our project engineers to refer the matter immediately through the division engineer to the Regional Federal Highway Administrator for engineering evaluation and then to my office for legal review. This insures that, while the work is still in progress and the facts are fresh in the minds of all parties, we can give the project engineer further advice and propose settlement terms. As a practical matter, we can also insure that the project engineer documents the claim adequately and obtains any data which are essential to settlement on the claim at a later date.

When the Federal project engineer and the contractor are in the middle of a construction project, during a limited construction season, there is a natural reluctance to do more than is really necessary with respect to claims which the contractor is not willing to resolve on the spot. We realize that cooperation and good relationships between the project engineer and the contractor and his work force must be maintained if the job is to be completed on time. However, the contractor must take the time to give notice of potential claims; the project engineer, as well as the contractor, must document those claims which cannot be settled by agreement or change order; and they must do it thoroughly enough so that there is no misconception as to the basis of claim at a later date.

I emphasize the need for solid documentation of unsettled claims. I find, in Federal claims work, that the primary reason for the inability to settle claims is the inability to reconstruct from the records kept, by both the project engineer and the contractor, the factual situation out of which the claim arose. This is why we must resort to extensive examination and cross-examination in appeals board proceedings. The mass of Federal case law that has grown up around construction contract claims is more than adequate to settle the claims. But the documentation must be equally adequate so that the parties can agree upon the basic facts of the claim. The same can undoubtedly be said of state claims.

If I had to develop an axiom at this point, it would be "A claim that is supported by clear and adequate documentation proceeds from strength." The measure of a state's



success on a particular claim for Federal reimbursement is necessarily the extent to which such claim is supported by adequate documentation. I would suggest that particular attention be given to the following categories of documentation of a construction claim:

1. The facts giving rise to a claim are most important. It has often been said that it is facts, to which legal principles can be applied which win law suits. We have received from some states claims for reimbursement, with a statement such as the following: "Since you are paying 95 percent of the bill and we are paying 5 percent, we would like your advice on whether we should pay this claim. The following facts appear to us to favor the position of the contractor." This naturally leaves us in some doubt as to what facts or law might favor the state in this claim. This is one reason why we like the claims reviewed by our division and regional engineering staff.

For every inadequately documented claim, we are fortunate in receiving many more which are accompanied by well-organized factual information, substantiated by correspondence, excerpts from diaries, photographs, pictorial diagrams, exhibits, and, finally, convincing argument and engineering evaluation encompassing the entire claim.

2. The legal basis for paying the claim. The engineer may make a very valid factual and engineering presentation for the settlement of a claim but if the proposed settlement is contrary to the law of the state in which the contract is made, the claim must fail. Therefore, you, as legal counsel, should be in on the ground floor in the development of the claim. We, in the Administration's Office of General Counsel, defer to your judgment, as State counsel, to know best what is the prevailing law of the state on a particular legal matter. Although we defer to your judgment, this does not mean that we succumb to it. We research the law you cite very carefully.

One of our most experienced private claims attorneys in Washington has this motto over his desk: "When all else fails, read the contract." What he is saying is that there are more solutions to be found in the contract provisions than the parties ever dreamed were there. And yet, it is surprising how many claims we receive from state highway departments which contain no reference whatever to specifications or to the contract provisions of the particular contract.

About a year ago we received a claim from a state highway department for work that had been performed on a project after completion of the work called for by the contract. The work had apparently been performed without the benefit of a change order or supplemental agreement by the parties and the only legal basis presented to us by the state for payment of the claim was a short excerpt from chapter 1 of Williston on Contracts to the effect that until a contract is fully performed it is executory and may be amended by the parties. State counsel was certainly safe in selecting chapter 1 of Williston because Mr. Williston does not begin hedging his legal principles until the later chapters. But we are still at a loss to understand what significance this legal principle has with respect to the claim presented—since the contract had not been amended. Lack of in-depth legal review is one of our many problems in the presentation by states of their claims, and we are understandably on the defensive. If you think this does not apply to you, I suggest you review carefully some of the claims which have been turned down by the Bureau of Public Roads in the past and then decide whether you could have presented a better legal position on behalf of your client—the state highway department.

3. Present an auditable claim. The great majority of claims are dollar claims and should, therefore, contain appropriate cost breakdowns from which state auditors, and in turn the Administration auditors, can audit the claim. Another problem is the basis on which claims are settled—total cost, costs related to contract unit prices, or opinions of experts ("jury verdict" basis). Therefore, the state highway department would be well advised to consult with Federal Highway Administration accountants to determine which cost principles would be most acceptable to them and to document the claim accordingly.

4. Argue from strength rather than weakness. Give us all the facts, all the law and all the figures necessary to support your claim but then argue from strength rather than weakness. I assure you we would like to be convinced that you are right. If you

want to be fully convincing you must substantiate everything you assert to the fullest extent possible, referencing specifications, contract provisions and the law of the State. Do not make statements which you cannot support. In short, if it is evident from your presentation that you are convinced of the validity of your claim, you will undoubtedly convince us also.

This is, in essence, all we ask of the states as a basis for determining their right to Federal reimbursement on most construction claims which they settle with contractors. I feel it would be unfair to the Federal Highway Administration for me to recommend any less than this. At the National Highway Claims Conference of the American Road Builders' Association in March 1967, I was pleased to hear John E. Harwood, Deputy Commissioner and Chief Engineer of the Virginia Department of Highways, take this same position with regard to the Federal-state relationship on claims; namely, that the state must assume the responsibility that it has under the contract with the contractor, and only the contractor, and render prompt decisions on and approvals of claims without regard to the possible position of the Bureau of Public Roads.

With respect to who is best qualified to document, present arguments and settle claims, we have found in the Federal program that this person is the engineer who is the contracting officer on Federal construction projects. We have no legal objection to a state administrative contract appeals board standing in the shoes of such a qualified state engineer or reviewing a decision made by him. The Federal Highway Administration would have an interest, of course, in the technical ability of members of such a board to understand and determine the engineering problems involved in the dispute. Again, we would expect the issues to be settled on the basis of the applicable contract provisions and specifications, state law, and such adequate documentation and cost analysis as would permit a detailed audit by our officials for purposes of Federal reimbursement. Similarly, an award made on the basis of a decision by a state court would have to be supported, in the record made before the court, by the applicable contract provisions and specifications, as well as by state law, since the reimbursement authority of the Federal Highway Administration is expressly limited under 23 USC 121 to those "costs of construction incurred by [the State] on a project. . . in accordance with the plans and specifications. . . ."

In the past, the Bureau of Public Roads has been asked to participate in a state contractor's claim which was approved by the state legislature. The Comptroller General of the United States (9 Comp. Gen. 175, Oct. 30, 1929) has held that there is neither a legal nor an equitable obligation on the part of the United States to pay to a state a sum of money for its Federal-aid construction merely because the state legislature passed a bill in favor of the contractor and the supreme court of the state later upheld such action as an obligation on the state highway department to submit a claim to the United States.

While on the subject of claims, we should not overlook the preventive responsibility we, as lawyers, have to our respective organizations to assist them in avoiding claims. When a claim arises and we are asked to interpret a contract provision, how many times have we found that there is such ambiguity in the provision that the claim can only be resolved by court action? We can serve our clients best if we promptly revise, for future use, such an ambiguous provision and any related provisions in order to "write out" future claims of a similar nature.

In other instances, the claim may have arisen because of misinterpretation by the project engineer or because of his failure to properly administer the work under the contract. We are using the "newsletter" approach to bring to the attention of our field engineers on Federal projects not only these types of recurring claims but also our recommendations as to how they might have been avoided by proper project administration.

We have heard complaints from some state highway department attorneys that the Federal Highway Administration division engineers in their states were denying claims which they felt both had merit and would have received favorable consideration from officials at the regional or Washington headquarters level. My only answer to this is to keep "pushing the button" until you receive consideration of the claim at the level

desired. You must use your own discretion in what decisions to appeal. Your working relationships with our division engineers would not be greatly enhanced were you to appeal every one of his adverse decisions regardless of the merits of the decision.

In conclusion, let me emphasize that a good claim will always be a good claim, to whomever it is presented. Although the Federal Highway Administration has a veto or second-guessing authority over the states in the area of Federal reimbursement, this authority will be exercised in a reasonable way. Most of our problems can be resolved by more effective communication. A complete and thorough resolution of the state claim, well documented, founded in state law and applicable Federal law and regulations, has assurance of acceptance by the Administration.



# Quality Control in Highway Construction Programs

DUKE W. DUNBAR, Attorney General of Colorado

•IN any engineered construction project, there are usually three, and sometimes more, parties involved. First, there is the engineer or designer, who determines and lays out in detail the work that is to be done. Second, there is the owner who is prepared to pay for having this work done, and who enters into a formal agreement with a contractor to do the work. And third, there is the contractor who undertakes to do the work, either by himself or through subcontractors. Beyond this little circle of people who stand in direct contractual relationship to each other are others—manufacturers, shippers, materialmen—whose contractual connection with the principal parties is more indirect, but whose activities must be coordinated in order to carry out the project.

Each of these parties—and I have intentionally oversimplified the list for purposes of illustration—has responsibilities to those with whom he has an immediate and direct contractual relationship, and, under certain circumstances, he may have responsibilities to others in this group. The important point is that these responsibilities are determined primarily by the terms of the parties' written contracts. And so, in these matters, the lawyer finds that the answers to most of his questions must be sought in the terms of contracts—designer-owner contracts, owner-construction company contracts, or construction company contracts.

In the eyes of the law, highway construction is no different from any other type of construction as far as the legal relationship of the parties to one another is concerned. There is, of course, some difference in the position of the parties where a state highway department is involved. In this instance, the state is both the owner of the land where the construction is to occur, and the employer of the engineer who designs the project. The highway department is in the normal position of the owner who contracts with a builder or construction company; and it also furnishes the plans for the project, and makes sure, through inspectors or supervising engineers, that the contractor performs the work in accordance with the intent of the contract and specifications.

## RESPONSIBILITY FOR CONTROL OF QUALITY

The matter of assuring that construction is performed according to acceptable standards of quality is customarily covered by contract and certain doctrines of law. To visualize the basic legal responsibility of the contractor one might take the possible, although not common, situation in which the owner agrees to furnish the materials needed for a project. In this case, the duty of quality control is laid upon him to the extent that the materials must be suitable for the intended use. To a great extent, his guaranty of suitability for use is like a sales warranty of merchantability or suitability for use.<sup>1</sup> Suitability, in this case, means more than mere technical conformity to specifications, and requires that the material be reasonably workable or suitable in every respect to the uses the construction company or contractor will make of it.<sup>2</sup>

If the owner fails to meet these standards of quality, the contractor has the right to require the owner to supply material conforming to these standards. Where defects

<sup>1</sup> *Warneke v. U.S.*, 156 Ct.Cl. 684 (1962).

<sup>2</sup> *Topkis Bros. Co. v. U.S.*, 297 Fed.2d 536; rehearing denied, 299 Fed.2d 952 (1962).

are latent, and the material is used in the project without the defect being noticed, the owner must accept the defective work or give the contractor an adjustment for correcting it.<sup>3</sup>

I have mentioned this unusual situation of the owner supplying the materials for the contractor in order to make a particular point. Here, presumably, is a case where there can be little or no question of having the correct materials for the job. Certainly if anyone ought to know what materials are wanted, it is the owner whose engineers have designed the project. But the usual case is one in which the contractor selects the materials after studying the highway department's specifications, and this introduces an initial difficulty to quality control. To minimize this difficulty attorneys representing state highway departments must use great care to draw the contract between the state and the contractor so that it clearly refers the parties to complete and workable specifications which will be binding on the work done and understood by the parties.

### IMPORTANCE OF SPECIFICATIONS IN HIGHWAY PROJECTS

By and large, the state highway departments have comprehensive and workable standard specifications, and suitable plans and special provisions for individual projects. That this is true is evidenced by the large dollar volume of contract work completed each year—work that is acceptable to the state highway departments, and more or less profitable to the contractors. We recognize, however, that our specifications are not perfect, and that in its actual operation the process of contract administration often varies markedly from the way it is conceived in theory. If this theoretical perfection existed in fact, we would have specifications which were incapable of misinterpretation by any of the parties involved with them. To be realistic, we are forced to admit that in contract administration we are no closer to mathematical perfection than we are in right-of-way acquisition when we seek to determine market value. And perhaps we cannot expect to attain this perfection, for, as one of our Supreme Court justices said many years ago, in discussing the definition of market value:

The brief seems to desire that courts shall reduce this question of market value and its application to the certainty of a mathematical demonstration. Until the human mind is cleared of the many infirmities that enshroud it, this consummation is impossible.<sup>4</sup>

In the drafting and administration of highway construction contracts, therefore, we must make the best of an imperfect world.

### SPECIFICATIONS FOR QUALITY CONTROL

The legal responsibility of contractors for quality control is one of the most important subjects to be covered in highway contracts. This responsibility will be determined by the terms of the contract document. It is obvious that, at least initially, quality control rests almost entirely with the contractor. This is so because, for the consideration stated in the contract, he has agreed to furnish the materials and services required by the contract in accordance with the state's specifications, which generally are incorporated by reference in the contract.

Most state and Federal-aid highway construction contract specifications are based on the Standard Specifications, Plans, and Special Provisions based on guidelines developed by the American Association of State Highway Officials. In these AASHO Guide

<sup>3</sup> Penn. Needle Art Co., WBCA 426; 2 CCF 1 (1944). Longwear, Inc., ASBCA 3607; 57-1 BCA par. 1269 (1957).

<sup>4</sup> Denver R. R. Company v. Howe, 49 Colo. 256, 112 Pac. 779.



Specifications, subsection 104.01 is particularly pertinent to our present discussion, and states:

The intent of the contract is to provide for the construction and completion in every detail of the work described. The contractor shall furnish all labor, materials, equipment, tools, transportation and supplies required to complete the work in accordance with the plans, specifications and terms of the contract.

This not only helps define quality as it should be understood by the parties, but also helps mark out the area of the contractor's legal responsibility for quality. He is responsible for the quality of materials, equipment and the like purchased by him from suppliers and manufacturers; and he is responsible for the quality of work performed by his subcontractors.

#### THE CRITERIA OF QUALITY: THE CONCEPT OF EQUALITY

Effective quality control cannot be achieved without a workable definition of "quality." In this regard highway construction standards are interpreted by reference to the plans and specifications for the project. These specifications may be either wholly descriptive or refer, in turn, to quality designations established by AASHTO or the American Society for Testing Materials. Where brand names are particularly well known in the trade and supplied by several manufacturers, the brand name "or equivalent" product may be called for. Where this latter style is used, an equivalent product is not understood to mean one that is identical with the brand name item,<sup>5</sup> but only that the item shall be as suitable to the actual needs of the project as is the brand name item.<sup>6</sup>

The significance of this concept of equality to our present discussion is that in practice it tends to divide the control of quality between the engineer-designer and the contractor, while technically under the law the final decision on acceptance rests with the former. Differences of opinion over the equivalence of materials will inevitably occur, and must be resolved. They will be resolved in a manner satisfactory to the highway department's supervising engineer whose standards shall be those of a reasonable person<sup>7</sup> rather than his personal preference.<sup>8</sup> Under these circumstances the contractor is free to select and use equivalent materials without destroying the effectiveness of the project's quality control.

#### THE CRITERIA OF QUALITY: TRADE PRACTICES

Application of quality control to the interpretation of specifications also necessarily involves recognition of accepted trade practices. A retaining wall that is specified to be "plumb," "true," or "vertical" is not required to meet the same tolerances required of, say, the launching structure for a space vehicle.

For example, in the construction of a hospital in New York, an inspector required the brickmason to use an engineer's level in leveling the bed joints, in plumbing the vertical joints, and maintaining the concave joints at uniform depth.<sup>9</sup> The court here held that these requirements exceeded the fair intent of the building specifications, and the quality required by the brickmason was to be determined by the accepted trade practice in laying bricks under similar specifications.

Trade practice would clearly have to be used as a reference for interpreting such a requirement as Oregon's specification that "the methods of delivering and handling . . . concrete shall be such as will facilitate placing with a minimum of rehandling and without damage to the structure of the concrete."<sup>10</sup>

<sup>5</sup> 38 Comp.Gen. 291.

<sup>6</sup> Comp. Gen. Dec. B 153452 (26 March 1964), unpublished.

<sup>7</sup> Fielding & Shepley, Inc. v. Dow, 163 p.2d. 908 (1945).

<sup>8</sup> Rockwood Mfg. Co. v. Mason Regulator Co., 66 N.E. 420 (1903).

<sup>9</sup> Arc Engineering Corp. v. State, 40 N.Y.S.2d 354; aff'd, 293 N.Y. 819 (1944).

<sup>10</sup> Oregon State Hwy. Comm'n., Standard Specifications for Highway Construction (Salem, 1964), p. 263.

## QUALITY CONTROL—TIME OF ACCEPTANCE

Questions will arise regarding the point or place of acceptance of materials. Obviously, it would not be practical to accept aggregate or cement after it has become part of the hardened concrete. Similarly, acceptance of these materials as they leave the manufacturer's hands involves the risk of deterioration of quality before they are actually used. Normally it is state practice to make the contractor responsible for aggregate and cement up to the time it enters the concrete mixer, even though these materials may have been provisionally accepted at the manufacturing plant.

The state's specifications should, and normally do, clearly state the time for acceptance for various materials. In addition, places of inspection pending acceptance are usually specified and must be adhered to in the inspection-acceptance procedure. As between the preliminary inspections at the plant, or those made at other times, and the official inspection provided for in the contract, the latter is the one that legally obligates the inspecting party and determines acceptance.<sup>11</sup>

## QUALITY CONTROL: STORAGE AND HANDLING OF MATERIALS

The specifications incorporated in the construction contract apply to the state's acceptance of the contractor's work, but they do not solve all of the problems of this sort which may arise during construction. From the contractor's viewpoint a whole series of vexing questions may arise when materials undergo changes in their quality during shipment, handling and storage between the time of manufacture and the time of use in construction. It is clear that the highway department may hold the contractor responsible at the time of use in the construction process, but where should this risk of loss ultimately be placed? The contractor, the supplier, and the manufacturer all are possible targets. In the last analysis, allocation of this risk is determined by the contracts they make among themselves.

To some extent the state can help clarify this question of liability by the guidelines set forth in its specifications. Subsection 106.01 of the AASHO Guide Specifications for Highway Construction states: "At the option of the Engineer, materials may be approved at the source of supply before delivery is started." Thus, even though it is understood that the highway department has the right to retest all materials prior to incorporation into a project, such previous testing may aid in assigning responsibility for an item subsequently found unsuitable.

As with many legal problems, however, the best solution to questions of liability for quality changes may be to prevent the question from occurring. Consider, for example, the case of aggregates which are particularly susceptible to "degrading"—that is, breakdown or deterioration into smaller pieces during hauling, handling, or exposure during storage out of doors. In this case, it is essential to have a definite point and time specified and to provide for early and periodic inspections. With these checks on quality, the amount of degradation may be anticipated and allowance made by the manufacturer or supplier for acceptance by the state's inspector at a certain time and place in the future. In other cases, the contractor may be able to allow for degradation during his screening and crushing operations.

The important point is that while the state highway department cannot completely relieve the contractor from the risk of quality deterioration during storage and handling, it can aid the contractor and the materialman in achieving a smoothly working arrangement under the contracts they have with each other.

## QUALITY CONTROL: INSPECTION PROCEDURE

While the highway department can accomplish much through careful drafting of contracts and substantive specifications, the ultimate success of quality control is likely to depend on good inspections.

<sup>11</sup> J.C. Decker, Inc. v. U.S., 117 Ct.Cl. 703; 93 F.Supp. 631 (1950); B.H. Deacon Co., Inc. v. U.S., 189 F.Supp. 146 (E.D. Pa. 1960).



Inspection procedure should be, and normally is, prescribed explicitly in the state's specifications. Where specifications are open to several interpretations, inspection and testing must be in accordance with accepted trade practices, and the burden is on the contractor to demonstrate that a disputed inspection technique in any particular instance is inaccurate or inappropriate.<sup>12</sup> The inspection must be reasonable, and defects found under an unreasonable inspection will not justify rejection of an item.

Most disputes in connection with inspection procedures arise out of cursory or haphazard inspection,<sup>13</sup> resulting in erroneous rejection of tendered items,<sup>14</sup> or overly strict inspection,<sup>15</sup> or tests beyond the requirements of the contract.<sup>16</sup> This type of dispute will inevitably arise in construction programs of such massive proportions as the current highway program. Procedural rules for state highway projects normally provide steps for settling them satisfactorily. To make such procedures work, however, the contractor must preserve his rights by protesting in a timely manner,<sup>17</sup> and all parties must cooperate in preparing and preserving accurate, complete records of the action that has occurred.

### QUALITY CONTROL: ADJUSTMENT PROCEDURES

A well-founded protest regarding an improper inspection, correction of an error due to defective design, modification of applicable specifications after work has commenced, or various other circumstances may be reason for adjustment in the contract price. Perhaps most common of all causes, however, are the variations in quality which materials exhibit, and the problems associated with material which is slightly "out-of-specs," or the occasional "test out of specs." Recognizing these problems, the AASHTO Guide Specifications provide that:

All work performed and all materials furnished shall be in reasonable conformity with the lines, grades, cross sections, dimensions and material requirements including tolerances, shown on the plans or indicated in the specifications.

In the event the Engineer finds the materials or the finished product in which the materials are used not within reasonably close conformity with the plans or specifications, but that reasonably acceptable work has been produced, he shall then make a determination if the work shall be accepted and remain in place. In this event, the Engineer will document the basis of acceptance by contract modification which will provide for an appropriate adjustment in the contract price for such work or materials as he deems necessary to conform to his determination based on engineering judgment.

This provision is extremely important to both the contractor and the highway department since it provides an alternative to outright rejection of nonconforming work and materials. Like many other procedures for handling deviations from the usual performance of administrative functions, however, this one requires a certain amount of formality and "paperwork"—modification of formal documents, and documentation of the reasons therefor. And here, of course, is a point where it is vulnerable, since engineers and contractors often have less patience—or apparent fondness for—paperwork than do administrators. Faced with the necessity of keeping a construction job on schedule, they will prefer to do whatever is necessary on the spot, rather than halt work until the necessary modifications can be processed through administrative channels for approval.

<sup>12</sup> Appeal of Smith & Nephey, ASBCA, 1487 (1953).

<sup>13</sup> Wabash Valley Packing Co. v. U.S., 63 Ct.Cls. 344 (1927).

<sup>14</sup> Standard Fish and Product Co. v. U.S., 74 Ct.Cls. 623 (1932).

<sup>15</sup> Thomas C. Edward v. U.S., 80 Ct.Cls. 118 (1934).

<sup>16</sup> Appeal of Stubnitz-Green Spring Corp., ASBCA 2608 and 3651 56-2 BCA Par. 1034 (1956).

<sup>17</sup> Woodcraft Corp. v. U.S., 146 Ct.Cls. 101; 173 F.Supp. 613 (1959).



One can easily understand these feelings. It would seem that here is an aspect of contract administration for which lawyers should be able to devise a procedure which is more realistic with respect to construction needs.

Another aspect of the contract adjustment process which merits study by lawyers is suggested by the question, often heard from contractors: "Why are we always wrong and the engineer always right?" One answer to this question—and perhaps the most straightforward one—is "Because it is in the specifications." Specifically, subsection 105.01 of the AASHTO Guide Specifications states:

The Engineer will decide all questions which may arise as to the quality and acceptability of materials furnished and work performed, and as to the rate of progress of the work; all questions which may arise as to the interpretation of the plans and specifications; all questions as to the acceptable fulfillment of the Contract on the part of the Contractor.

It is evident, however, that disputed claims are not always resolved by the engineer acting under this section of the specifications. Where they are not, the contractor may take the matter through channels to the engineer's superiors in the highway department, or to an appropriate committee of his contractors' association. Ultimately, of course, he may go to court. In Colorado, we feel that channels are relatively clear for the contractor to state his case first with the project engineer, then the district construction engineer, the district engineer, and the assistant chief engineer for operations. In practice recourse to this channel of administrative review and appeal has resulted in successfully adjusting the vast majority of claims arising from deviation from quality control standards in this state.

Elsewhere this problem may be more critical. Where this is the case, there may be merit in considering the establishment of a body within the framework of the state government to perform for the state's highway program the same functions that the Armed Services Board of Contract Appeals performs for the nation's massive military procurement program. I do not suggest what the details of this solution would be; I suggest it merely to urge highway lawyers and administrators to observe what is happening in other public programs involving large-scale contractual arrangements, and adapt from these programs whatever may be appropriate to the construction of highways.

Cooperative efforts to prevent the occurrence of disputes are, of course, as important as settling them. In this regard, the Colorado Department of Highways was the first to establish a Joint Cooperative Committee with the state contractors' association.<sup>18</sup> This committee affords an opportunity for contractors' association representatives to present problems to representatives of the highway department and vice versa. The joint efforts of this committee have been successful in achieving mutually satisfactory solutions to problems regarding specifications requirements and policies of the department regarding their interpretation and enforcement. On the national level somewhat similar cooperative efforts are carried on by a joint committee of representatives of the American Association of State Highway Officials and the American Road Builders' Association.

## THE ROLE OF RESEARCH IN HIGHWAY CONTRACT ADMINISTRATION

The contract law that highway departments and construction contractors are concerned with is largely administrative law. By that I mean that in most cases contract problems are handled and settled by administrators applying engineering judgment within the framework of legal rules and standards set forth in the state's construction specifications and contracts. In this respect it differs from right-of-way acquisition which generally is carried on through the judicial process. Whereas the law of eminent domain is worked out under the rigorous supervision of courts, much of the law

<sup>18</sup> This committee is composed of sixteen members—seven from the highway department, appointed by the Chief Engineer; and nine from the state contractors' association.

of contracts continues to be evolved through the more loosely controlled processes of administrators and engineers by their accommodation of the terms of contracts and formal specifications to the realities of construction practice. In such circumstances, it is inevitable that the law on the books sometimes bears little resemblance to the law in action.

There is obvious danger in letting the law in the lawbooks grow too far out of harmony with the law in action. This is amply documented by the investigations of the Blatnik subcommittee. This danger can be substantially reduced by highway lawyers if they will use their efforts in preventive measures.

If the states' procedures for quality control are so unrealistic that supervising engineers and contractors feel they cannot take the time to comply with them as they were originally intended, these rules should be made workable.

If the concept of privity of contract acts as a curtain hiding the problems of the materialman or subcontractor from view when in reality these problems have an important bearing on the successful performance of the prime contractor's agreement with the highway department, the modern application of this legal concept should be re-examined.

In short, if we are to improve contract administration, there must be some new and searching study of the legal framework of this function, and a thorough analysis of the factors that affect it and the public policies it serves.

Sound research on these problems will have to be the product of pooling the talents of lawyers, engineers, administrators and contractors. In this respect, I would like to call attention to an NCHRP Report, "Development of Guidelines for Practical and Realistic Construction Standards."<sup>19</sup> It is a report on the definition of work and materials, the basis for acceptance or rejection of contractors' performance, and a philosophy for modernizing the preparation of construction specifications. It is a valuable addition to highway research as it now stands, but it could have been made a much more significant contribution if the legal aspects of this subject had been given the major attention they deserve. As written, this report contains more than 100 pages, in which only two paragraphs comprised of 291 words are devoted to the legal requirements of contract specifications. I submit this report could have been made much more valuable if the legal context of this problem had been treated by the researchers.

As the Interstate Highway System program moves from the stage where right-of-way acquisition has top priority into the stage where construction efforts are the primary concern, I hope that highway administrators will accept this challenge of the times and call for research on the various problems of contract administration. When they do, I hope such research will give adequate treatment of the legal context of contract administration.

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<sup>19</sup> Highway Research Board. Development of Guidelines for Practical and Realistic Construction Specifications, NCHRP Report 17, 1965.

# Trade Association Information Exchanges Under the Anti-Trust Laws: Compulsory or Open Competition

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•PERHAPS the most spectacular recent development in consent decrees involving information exchanges has been in the direction of compelling the exchange of information of a quite different kind than has been usual in the past. This is probably symptomatic of the oligopolistic conditions now prevailing in many of our major industries. Thus, the government recently worked out a consent decree against General Electric which proposed, among other things, that the price of each component of a total bid on a job be itemized and made available to all other firms in the industry. This novel provision was proposed on the theory that such information might enable a smaller firm to compete for part of a large contract by bidding the low price on individual parts. Actually, the government succeeded only in inserting provisions against refusing to sell circuit breakers to any firm which might in turn sell them to manufacturers of equipment in which they would be incorporated and in authorizing a kind of joint bidding which would be helpful to smaller firms.

The need for these provisions in a consent decree so underscores what has happened in American industry that it can well serve as a point of departure from which to survey the past six or seven decades of development under the anti-trust laws, particularly as they relate to information exchanges.

I propose to examine such examples as they have related to price fixing in the following sequence: (a) starting with the Addyston Case in 1898; (b) then at the phenomenon of delivered pricing as a method of price fixing based on information exchanges; (c) next at the so-called "open price" developments which were initiated by the lumber interests in the 1920's; (d) then at the consent decrees which would interfere with the exchange of cost information; (e) then at the present G. E.-Westinghouse price conspiracy and some of the novel provisions which the Department of Justice sought to include in a consent decree against G. E.; and (f) finally at recent proposals for remedial action which might get us off the horns of the dilemma which we find ourselves in, which compels us on the one hand to break up price-fixing schemes in the nonregulated industries and then immediately counter with decrees which seek to deter the giants of an industry from competing too vigorously on a price basis so as to destroy the marginal producer protected by the illegal price-fixing schemes.

## THE ADDYSTON CASE<sup>1</sup>

In the 1890's a trade association known as the Southern Associated Pipe Works was developed as a vehicle for price rigging and market allocation by the industry. The information exchanged consisted of data necessary for a scheme in which (a) certain cities were reserved for sales by designated members of the association; and (b) bids were set on jobs in the remainder of the territory by an association with the member getting the right to low bid who was willing to put the highest portion of profit into a

<sup>1</sup>United States v. Addyston Pipe & Steel Co., 85 Fed. 271 (C. A. 6, 1898).



kitty, for division on the basis of capacity, among association members. The purpose was alleged by the association to be to avoid ruinous competition and to allocate a fair share of the work at such reasonable prices as would enable all members of the industry to continue in business. The purpose proved by the Government was to hold, by agreement, prices at levels such as to make it unprofitable for producers outside "pay territory," as it was termed, to compete.

This was a relatively simple scheme based on the notion that pipe would not come into "pay territory" under the cost of production plus freight. These were little recognition of the effect of fixed and variable costs pursuant to which, if in fact any contribution could be recovered on such fixed costs, freight would be absorbed and pipe shipped in. But in the reserved cities, far from outside competitors, the effect of the agreement was to eliminate by agreement nearby competition which could absorb freight and still enhance total profit per ton. The exchange of information allegedly to avoid ruinous competition was a price-fixing and market-rigging scheme, and illegal per se under Section 1 of the Sherman Act.

#### DELIVERED PRICING: PITTSBURGH PLUS AND MULTIPLE BASING-POINT SYSTEMS

In the steel industry, price fixing centered around the use of basing point systems. These involved extensive exchanges of information as to railroad rates since the system of price fixing revolved around a base price for steel in Pittsburgh plus railroad freight from this point. This enabled the then dominant Pittsburgh producers to enter any market which they chose. At the same time all other producers eliminated price competition among themselves. Even though inefficient producers could not meet the Pittsburgh price cost-wise, they were able to take a market share because of the "phantom freight" from Pittsburgh to points which might be much nearer to them than Pittsburgh would give them a margin which could absorb the additional cost of the inefficient producer and still leave a profit. They would not be encouraged to expand production, however, since Pittsburgh prices were based on an efficient producer which could cut its prices to keep other producers in line. "Place economy" was thus effectively defeated. In the South, U. S. Steel acquired the Tennessee Coal and Iron properties and directly controlled their pricing and development.

With the outlawing of "Pittsburgh plus" pricing in 1924, multiple basing-point pricing was developed, permitting less dominance by Pittsburgh producers but still preserving price inflexibility. While market allocation or sharing directly was not permitted under the Sherman Act, as demonstrated by the Addyston case, multiple basing-point systems nonetheless achieved some degree of market allocation by assigning basing point mills throughout the country which all producers could quote prices from, plus freight, whenever a customer was closest to the mill.<sup>2</sup> This resulted in uniformity

<sup>2</sup>An abstract of the bids for 6,000 barrels of cement to the United States Engineer Office at Tucumcari, New Mexico, opened April 23, 1936, shows the following:

<u>Name of Bidder</u>	<u>Bid Price per Barrel</u>
Monarch	\$3.286854
Ash Grove	3.286854
Lehigh	3.286854
Southwestern	3.286854
U. S. Portland Cement Co.	3.286854
Oklahoma	3.286854
Consolidated	3.286854
Trinity	3.286854
Lone Star	3.286854
Universal	3.286854
Colorado	3.286854

All bids subject to 10 cents per barrel discount for payment in 15 days. (com. Ex. 175-A). See 157 F.2d 576.

of price quotations to the producers but varying returns to producers depending on where they were located vis-a-vis the purchaser. The market could be reached by any producer who was willing to absorb the additional freight charge, and he would absorb freight if he needed the production badly enough, and if the price received would leave something after freight charges to apply to his fixed charges. If he did not, the sales would presumably go to those to whom they were most profitable on the basis of customer allocation. The Cement Institute Case<sup>3</sup> in 1948 spelled the beginning of the end for the multiple basing-point system and its facilities for fixing prices, market sharing and enforcement.

### "OPEN" COMPETITION

Where an industry had no dominant members who could set a price and make it stick because of potential ability to undersell competitors in any market, the trade association information exchange became a far more important factor. Exchange or circulation of freight charges from various points of basing were not enough to secure uniformity of pricing in such an industry.

Such circumstances prevailed in the lumber industry in the early decades of the century, and the "open competition" plan of the American Hardwood Manufacturers' Association came into being as an attempt to deal with competition which was proving too vigorous. The plan was brought to the Supreme Court for scrutiny in a Government suit for injunction in 1921. Because it involved not only the reporting and exchange of past transactions including costs, but also projections of demand into the future, with strong suggestions for curtailing production as a cure to oversupply, it was held to be an unlawful restraint of trade and enjoined.

Thereafter another segment of the lumber industry came up with a plan which deleted all attempts to project exchanged data on costs and supplies into the future or to in any way persuade members as to future programming of prices or production. Despite the protests by the Government that this too was an attempt to stabilize prices by conspiracy, the decree against the association's activities was dissolved by the United States Supreme Court.

Thus a plan of statistical reporting and disseminating was approved which, while involving no coercion, could in fact be used to "suggest" standard prices. Basically, the plan consisted of determining an average industry "cost" for flooring plus a suggested percent on the value of the plant. If such suggested cost, plus a uniform margin of profit, was adhered to as price by the industry, it is obvious that the plan could achieve standard prices for the industry. Combined with basing-point delivered pricing using uniform railroad freight rates, it could eliminate variations arising from the fact that some purchasers might have more economical transportation available to them.

As a result of this validation of information exchanges as to past transactions and past costs, such activities grew and prospered. Only where they were coupled with agreements as to price has either the Department of Justice or the Federal Trade Commission been successful in enjoining them. Nor has the Federal Trade Commission been successful in attempts to stop such exchanges under its broad powers to suppress "methods of unfair competition." Seemingly, standing by themselves, exchanges of past information continue to be valid. However clearly they may be a factor in the stabilization of prices, they are not yet an unreasonable restraint of trade.

Some years ago, however, the Department of Justice did succeed in inserting in a consent decree against a trade association and its members provisions precluding exchange of cost information and circulation of average costs. But these provisions were ancillary to portions of the decree addressed to forbidding participation in a combination or conspiracy as to fixing or maintaining prices or to using any means, including trade association activity, to exact adherence to price-fixing schemes and might not have been obtained by themselves.

<sup>3</sup>Federal Trade Commission v. Cement Institute, 333 U. S. 683 (1948).



## THE GENERAL ELECTRIC-WESTINGHOUSE "EXCHANGES"

An aspect of behind the scenes trade association activity which had reluctantly enjoyed the spotlight in the Addyston case in 1890's, and in the 1920's and 1940's in the Trenton Potteries, U. S. Steel, and Cement Institute cases, came again into the public eye in the late 1950's and early 1960's in what has been called "The Great Price Conspiracy" in the electrical industry.<sup>4</sup>

At "off the floor" gatherings of industry leaders attending meetings of such organizations as the Edison Electrical Institute, the National Electrical Manufacturers' Association, and the Heat Exchange Institute, "exchanges" were going on with respect to allocation of markets and price maintenance—exchanges between competitors which ran squarely into the prohibition of Section 1 of the Sherman Act. They were engendered, it seemed, by G. E. charges that Westinghouse was trying to get a larger share of the available market through price cutting. Despite directives from the top, ostensibly ordering compliance with the anti-trust laws, men in lower echelons engaged in what have come to be known as "the phases of the moon conspiracies," so named because the lunar changes were relied upon to program and pace price rigging engaged in by the conspirators.

One commentator has summarized the procedure at a typical "information exchange" somewhat as follows:

There would first be a discussion of previous jobs awarded and particularly whether there had been respect by other conspirators for the designated low bidder on the job. These discussions were quaintly designated as "bitching sessions." Discussion would then turn to future jobs, the specifications for which had usually been circulated. Representatives would submit their calculated book prices for jobs and eventually agreement would be reached on a uniform book price for each job. Subject to an overall rotation scheme, allocation of bid positions would be made on the basis of manufacturer arguments as to their qualifications for the job or simply by the drawing of lots for low position if agreement could not otherwise be reached. Low bids would be fixed at a percentage above low bid.<sup>5</sup>

A cumulative list of sealed bid business was kept so as to check the relative standing of each company with its agreed percentage of total sales, and so as to make sure allocation of upcoming business would be consistent with it. Positions on bids would be rotated and generally controlled by a formula utilizing the phases of the moon to achieve what was called "cyclic rotative positioning." On certain business, G. E. was to get 39 percent, Westinghouse 35 percent, ITE 11 percent, A-C 8 percent, and Federal Pacific 7 percent, reflecting, presumably, respective capacities of each. These activities brought indictment and ultimate convictions under the Sherman Act to some 29 companies and some 52 individuals. Fines aggregating almost \$2,000,000 were assessed and seven individuals went to jail for terms of 30 days. And the story is by no means over, since just a month ago (March 1964) trials began which will determine how much of the prices charged during the conspiracy must be returned with damages in private suits under the Clayton Act. In the pilot case now in process, two Philadelphia utilities are seeking some \$37,000,000 in damages from G. E., Westinghouse, and several smaller firms.

Interest centers, however, in the consent decree by which the Government seeks to avoid such price-fixing conspiracies for the future. To place G. E. in a compliant frame of mind, the Department of Justice threatened to ask a split-up of G. E. if a

<sup>4</sup>Herling, J. *The Great Conspiracy: The Story of Anti-Trust Violations in the Electrical Industry*. New York, David Makay, Inc., 1962.

<sup>5</sup>*Ibid.*, p. 105-106, 129.



satisfactory consent decree could not be worked out. Such a split-up might be possible, of course, on the basis of the Clayton Act approach successfully employed by the Government in the General Motors-Dupont case.

G. E. officials balked at one major provision in the proposed consent decree—a provision that would bar the company from selling at "unreasonably low" prices where there is "a reasonable probability that the effect would be to substantially injure competition or tend to create a monopoly." The Government sought by such a decree to protect the smaller competitors against the effects of deep price-cutting. G. E. officials quite naturally bristled at the idea of being told to "compete vigorously but not too vigorously." This is understandable since their fingers have been severely burned in their efforts to achieve this objective, of not too vigorous competition, by recent convictions. They were asked to hold a price "umbrella" over the industry and thus to protect the less efficient producers, something they would argue they had just been punished for doing. They preferred to shift the burden of proof to the Government through a provision which would prohibit low prices quoted "with the purpose or intent" of stifling competition. The Government would be charged, under such a provision, with proving unlawful intent. It would obviously be much simpler to prove that competitors had been injured and that pricing of G. E. was tending toward a monopoly as would be the Government's task under its proposal.

The pressure to "carve up the market" among the industry was sought to be avoided in part by a new type of "information exchange." The Government proposed that all firms itemize the price of each component making up a total bid so that smaller firms might at least bid on parts of a contract even though unable to make a complete bid. Limited point bidding was also authorized, thus permitting smaller manufacturers to bid on at least part of a job.<sup>6</sup>

We have examined the results of anti-trust decrees, based upon full hearing and findings and based upon so-called consent. Each practice dealt with and curbed or outlawed either recurs in slightly different form in the same industries or recurs in

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<sup>6</sup>The following excerpt from a decree in *United States v. General Electric Co.*, Nr. 7058, reported in CCH Trade Regulation Reports (68-55, Dec. 26, 1962), illustrates this approach:

Nothing contained in this Final Judgment shall be deemed to prohibit any of the consenting defendants,

(A) Where in order to sell or offer to sell electrical equipment which included any circuit breaker any person must have an item or items of electrical equipment (i) which it does not itself manufacture, assemble, or purchase from others, (ii) or if it does manufacture or assemble such an item, the item is of such a type or quality that it cannot competitively sell or offer to sell its own item, (iii) or where such person could not singly perform the contract contemplated by such sale or offer to sell:

(1) from formulating or submitting, in combination with any person, a bona fide joint bid or quotation, where such joint bid or quotation is denominated as such or known to the purchaser as such; or

(2) from conducting bona fide negotiations for or entering into any lawful agreement with any person for a bona fide purchase from sale to each other,

(B) Where required directly or indirectly by a governmental agency, from formulating or submitting a combination with any person a bona fide joint bid or quotation which is denominated as such or known to the purchaser to be such;

(C) From entering into, creating, carrying out or implementing by lawful conduct any otherwise lawful contract, agreement, arrangement, understanding, plan or program with any reseller to the sale of any circuit breakers purchased from the defendant, or

(D) From lawfully contracting with any person for the supply to or by such person of any circuit breaker embodying the proprietary design of, or specially designed for, the purchaser upon terms prohibiting the supplier from selling equipment embodying such design to all others (except that the purchaser may authorize sales for repair or replacement purchases).

new industries in the same form. And now, with almost every industry dominated by a handful of firms, even without exchange of information prices may be set without benefit of competition.

Can we get ourselves off the horns of our dilemma? Can we enforce the anti-trust laws against price-fixing and market-sharing in order to protect against exploitation of consumers, without precipitating a situation in which overvigorous competition from the giants in the industry will kill off the competitors and again threaten us with the evils of monopoly?

The proposals of the Government's decree of consent against General Electric provide answers which require a great deal of supervision by the Government to see that they work. Are there other ways available to us which will be more likely to restore the operation of a competitive market and assure us of reasonable prices, efficient allocation of resources, and an appropriate pace of technological progress?

Some argue persuasively that bigness even in an age of automation may not necessarily supply the most efficient producer. Could we require that a showing be made that the size of an industrial unit is justified by "economics of scale," and if such showing is not made, that the unit be reorganized into smaller units? While automation requires large units in most instances, may not some of the alleged savings of bigness turn out to be the ability to come up with a smaller tax bill because of diverse operations, some profitable and some unprofitable, which can be offset against each other? Even in research, may it not be that smaller units, utilizing government and university research facilities to the fullest degree, may do as well; or that research units may successfully operate independently of industry serving large and small on an arm's length fee basis?

Others argue that we have not had a really free economy for a couple of centuries and that reliance upon the marketplace as an efficient allocator of resources and equitable distributor of purchasing power is a fantasy which it is folly to pursue; competitors will inevitably distort legitimate exchanges of information, essential to intelligent production, into devices for price-fixing and market-sharing. This being so, it is suggested that our only alternatives are government regulation, including outright government price-fixing.

Our experience with price-fixing in the regulated public utility industries and with business generally during World War II through O. P. A. has hardly been so successful as to make this route attractive. Yet we know that monopolistic or trade-association price activity cannot be relied upon to protect the public interest.

Perhaps progress in the future lies in a direction recently pointed out by Gardiner Means, the economist who charted the development of the modern corporation with Adolph Berle some thirty years ago in the classic work, "The Modern Corporation and Private Property." Means suggested that we devote our efforts to turning the management of our giant corporations from the search for the greatest profit as a goal to the public interest goals of insuring: (a) that price be in reasonable relation to costs; (b) that benefits to labor and to capital arising from production be reasonably related to their respective contributions to production; (c) that as nearly as possible, optimum use of resources be made so that no more of a given resource is used than is necessary for the end product and that combination of resources is used which involves the least cost; and (d) that there be technical progress to reduce costs, improve product and introduce new products. Means suggests that through an "economic performance act" we set up government rewards for management achieving these goals.<sup>7</sup>

<sup>7</sup> Means, G. C. *Pricing Power and the Public Interest*. New York, Harpers, 1962.

# Proof of Value in Eminent Domain Leasehold Interests

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•THE valuation of leasehold interests is the estimation of value of a partial interest in real estate. Similar valuations apply in cases of life estates, easements, fractional interests in cooperatives and condominiums, and interests of third parties created by action of protective covenants, deed restrictions, zoning and building regulations and other police powers. Leasehold interests are generally of the following types:

1. Physical improvements placed by the lessee;
2. Bonus value created because the present rent value (economic rent) exceeds the rent established by the lease rent (contract rent); and
3. A combination of the two.

In the instance of physical improvements, the measurement of value is the present value of the improvements. This situation presumes no bonus value to the lease and also is based on the supposition that the improvements are proper for the site. If surplus income is present (contract rent exceeds economic rent), the leasehold value of the improvements is eroded in the amount of the capitalized value of the surplus income.

Existence of bonus value in a lease is the more common type of leasehold interest developed. Such a condition may result when

1. The property is leased to a party in interest (family or corporate relationship);
2. Tax consideration may promote reduced rental level;
3. The lease is created as part of a sale-leaseback transaction;
4. Knowledgeable tenant may have secured a rental below the market;
5. Rent established may be incidental to transfer of business, inventory, good will or franchise;
6. Rental concession is given to get base tenant;
7. Rental concession is given to keep out competitors; and
8. An increase in present rental levels creates a bonus value where the property was leased some time ago at the market level which is below that now prevailing.

When under any of these or similar circumstances the contract rent is below economic rent, a leasehold interest in favor of the tenant exists. Whether the feeholder wishes or not, he is now sharing the value of the property with his tenant.

The interests of this group lie primarily with leasehold interests encountered in condemnation actions. Similar appraisal problems evolve in taxation, mortgage lending, estate evaluation and other areas.

A recent case of interest is where the leasehold of the Houston Astrodome was set for property tax purposes at \$1.00. Four appraisers for the county had estimated the leasehold value in the range from \$9½ to 12½ million.

The typical types of leases encountered are as follows:

1. Flat or ungraded. This is the most common lease in existence—constant rental per period over term of lease.



2. Step up (or step down) rents are graded up (or down) over term of lease in varying increments.

3. Revaluation—pegged to value of property with periodic rental adjustments.

4. Percentage—usually tied in with percentage of gross sales.

5. Index—lease periodically adjusted in accordance with change in some established price index.

We may encounter these singly or in varying combinations. For illustrative purposes we shall stay with the flat or ungraded lease, thereby avoiding involved mathematical computations.

## VALUATION

The same valuation techniques utilized in other appraisal problems apply in leasehold evaluation. The first step in evaluation of leasehold interest is estimating the value of the property being acquired. In many instances, this is the end of the valuation process as far as the acquiring agency is concerned. In other instances, division by interests is required. Condemnees are most interested in securing a breakdown in order to effect a payout of condemnation award. In the case of the acquisition of an entire property, the initial value finding is of the entire property. The next step is to estimate value of the individual interests. The valuation techniques considered are the market, cost and income approaches to value. If we are fortunate, we may have leasehold estates that have been transferred in the market that we can use as value indicators. In the case of physical improvements to the property, we will find the cost approach a helpful tool in our value estimation. The greatest reliance usually goes to the income approach because the analysis is basically that of an income stream.

The leasehold position has been related to that of an equity position while the leased fee has been considered to have the similarity to a first mortgage in a typical real estate transaction. Rates of return anticipated generally follow this ranking of position.

In examples of calculation of leasehold interests we will attempt to reflect the development of the interests in an entire acquisition of a property and also the situation that appears in a partial acquisition. For sake of simplicity, no improvements are included.

In all instances, we assume a net lease with an economic rent of \$6,000 per year or 6 percent return based on a current land value of \$100,000. Five years remain of a ten-year lease which carries a contract rent also of \$6,000 per year. In this instance, no bonus lease value exists; and, as a result, no leasehold interest is created. The lessor's interest could be calculated as follows:

Present worth of income stream

(P. W. of \$1.00 per year for five years discounted

at 6% is 4.212)

\$6,000 × 4.212 =

\$25,272

Present worth of reversion

(P. W. of \$1.00 five years hence discounted

at 6% is 0.7473)

\$100,000 × 0.7473 =

74,730

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\$100,002

Say \$100,000

The lessor's interest is made up of two components—the five-year income stream and the return of his property five years hence. The rental has the characteristic of an annuity being received in periodic payments in accordance with a contract (lease). For this reason, it has been discounted to a present value. The reversion (property return five years from now) has also been discounted because it is not immediately available to the owner.

Because the two components are quite different in their characteristics, it may be proper to ascribe dissimilar interest rates to reflect relative risk. Let us assume an uncertain or risky rental market which would cause an investor to seek a rate of 8 percent.

The investor anticipates that land values will be going up at a rate of  $1\frac{1}{2}$  percent a year indicating a value at the end of five years of \$107,500. Seven percent is considered the rate an investor would require for this type of investment. We then use 7 percent in calculating the present worth of the reversion.

Present worth of income stream

(P.W. of \$1.00 per year for five years discounted  
at 8 % is 3.993)

\$6,000  $\times$  3.993 = \$23, 958

Present worth of reversion

(P.W. of \$1.00 five years hence discounted at  
7% is 0.7130)

\$107,500  $\times$  0.7130 = 76, 647

\$100, 605

Say \$100, 000

In these examples, we have indicated that a 6 percent overall rate to establish rentals in the market does not necessarily mean that all components need be processed at 6 percent. The appraiser's function is to estimate market reaction, using this as a base for his value findings.

The use of an overall rate developed from the market is an excellent tool, but it must be properly analyzed. Most leased properties not only have the income stream to weigh but also an accompanying expense schedule to be considered. The reversion must consider the value of the parcel a number of years from now. Will the building improvements rapidly lose value? Or will a high level of maintenance coupled with probable continuing decline of the dollar result in no apparent dollar depreciation? This may be augmented by an increase in total value caused by upward movement in land values. Downward trends anticipated over the life of the lease would have an opposite effect.

The reversion portion is of prime importance in short-term leases (usually considered less than ten years). In the examples given, a five-year reversion indicates between 70 and 75 percent of value. The 6 and 7 percent factors for ten years are 56 and 51 percent. The factors for the same rates at 40 years are about 10 and 7 percent. The calculation of the reversion portion may, as a practical matter, be disregarded in extremely long-term leases. The effect on value is not significant.

Let us now examine the same property as above with the only change being that the contract rent under the lease is \$4,500 a year. The lessee is in the fortunate position of paying \$1,500 a year less than the going rent for the property. Because of this, the lessor is sharing the property value with the lessee. What are the relative positions of their holdings?

The contract rent has great likelihood of payment because it is substantially below the market (25 percent). Small declines in rental levels would have little effect on this rental stream as compared to rental payments of \$6,000. The lessor's position is sheltered, and it is reasonable to anticipate an investment of this type would bring less than the market rate for the entire property, say  $5\frac{1}{2}$  percent. The reversion will be considered unchanged at the 6 percent rate.

The lessee's position is less certain. His interest is more exposed and subject to erosion. Because of great risk, the return expected would reasonably be at a rate above that of the entire property, say 7 percent. The lessor's interest may be calculated.



Present worth of income stream	
(P.W. of \$1.00 per year for five years discounted at 5½% is 4.270)	
\$4,500 × 4.270 =	\$19,215
Present worth of reversion	
(P.W. of \$1.00 five years hence discounted at 6% is 0.7473)	
\$100,000 × 0.7473 =	74,730
Lessor's interest	\$93,945

The lessee's interest may be calculated

Present worth of income stream	
(P.W. of \$1.00 per year for five years discounted at 7% is 4.100)	
\$1,500 × 4.100 =	6,150
Total	\$100,095
	Say \$100,000

The results indicate that the value total of the interests approximates that of the entire property. The values of these fragmented portions of the entire property may result in totals that may be above or below the value of the total property. The individual interests may be more or less desirable as an investment vehicle at a particular time in a particular market. This is in keeping with fragmentation of other property. Land is subdivided because smaller parcels bring a greater total return than the original large parcel. But at times we speak of assemblage value when small parcels are put back together to form a large parcel that has a greater unit value than its components.

In the case of an entire acquisition we have estimated the entire property value at \$100,000. The lessor's interest is considered to be \$93,900 and the lessee's interest \$6,100.

Under the common law rule applicable in most jurisdictions, the acquisition by eminent domain of an entire property will terminate a lease. Condemnation clauses in the lease may result in a different distribution of the award than has been computed.

In the acquisition of only a portion of the property by eminent domain, the lessee's obligations generally are not relieved. Exceptions, of course, are created by specific lease and statutory provisions.

Let us examine a partial acquisition from the property previously studied. Forty percent in area of the parcel is being acquired. Severance damages to the remainder are considered to result in a total loss in value of 55 percent. We proceed on the basis that the loss of a portion of the property does not relieve the lessee of contract rent obligations. The same interest rates for the different interests involved will again be used. In this instance, we will initially estimate damages accruing to the lessee's interest.

Before value of entire property	\$100,000
After value of entire property	45,000
Total loss in value	\$ 55,000
Contract rent \$4,500 per year	
Economic rent 6,000 per year	
Acquisition and damage data	
Value of portion acquired	\$40,000



Contract rent for portion acquired	\$ 1,800
Economic rent for portion acquired	2,400
Damages to remainder, 25% or	15,000
Contract rent for remainder	2,700
Contract rent for depreciated portion of damaged remainder	675
Economic rent for remainder	3,600
Economic rent for depreciated portion of damaged remainder	900
Lessee's interest	
A. Present worth of contract rent for portion acquired (P.W. of \$1.00 per year for five years discounted at 5½% is 4.270) \$1,800 × 4.270 =	7,686
B. Present worth of bonus value ((\$2,400 - \$1,800 = \$600 rent saving for portion acquired) (P.W. of \$1.00 per year for five years discounted at 7% is 4.100) \$600 × 4.100 =	2,460
C. Present worth of reduction in contract rent of the remainder due to damage to the remainder (P.W. of \$1.00 per year for five years discounted at 5½% is 4.270) \$675 × 4.270 =	2,882
D. Present worth of reduction in bonus value of remainder due to damage to remainder (\$900 - \$675 = \$225 rent saving for portion damaged) (P.W. of \$1.00 per year for five years discounted at 7% is 4.100) \$225 × 4.100 =	992
Total lessee's interest in award	<u>\$13,950</u>

The lessee's interest in the award is made up of two components. The first is discounted future rent for property no longer available to him. This includes the portion acquired for use and the diminished utility of the remainder (Items A and C totaling \$10,568). The second portion is the present worth of the bonus value of the property acquired (Items B and D totaling \$3,382).

The lessee's remaining interest in the property may now be calculated:

Present worth of income stream of bonus value of de- preciated remainder (\$2,700 - \$2,025 = \$675) (P.W. of \$1.00 per year for five years discounted at 7% is 4.100) \$675 × 4.100 =	\$2,768
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After the acquisition the lessee has received payment for the bonus value of the property acquired (\$3,382) which when added to the bonus value of the remaining property of \$2,768 totals \$6,150 which is the value of the lessee's interest as originally calculated.

The lessor's interest may now be calculated:

Lessor's interest

Present worth of income stream	
(P. W. of \$1.00 per year for five years discounted at 5½% is 4.270)	
\$4,500 × 4.270 =	\$19,215
Present worth of reversion	
(P. W. of \$1.00 five years hence discounted at 6% is 0.7473)	
\$45,000 × 0.7473 =	33,628
Division of award	
\$55,000 - \$13,950 =	41,050
Total lessor's interest	<u>\$93,893</u>

Adding the lessor's interest of \$93,893 to the lessee's interest of \$6,150 results in a total of \$100,043, rounded to \$100,000.

Another phenomenon often encountered in dealing with leaseholds is the situation where contract rent exceeds economic rent creating what is termed surplus income. This may be capitalized into a value indication that is in excess of the total value of the property. Typically, this is not considered under the undivided fee rule which generally states,

No contract between owners of different interests in land can affect the right of the government to take the land for public use, or obligate it to pay by way of compensation more than the entire value of the land as a whole.

Sandwich lease is a term utilized to describe the situation where one or more sub-lessees are involved with the original lessee being in the inside of the sandwich. Leasehold interests may be created at any level in such a situation.

#### SUMMARY

Evaluation of leasehold interests is similar to other appraisals in that an attempt is made to measure the market reaction to value of a portion of the property interests as well as the entire property. Procedures must follow the requirements of applicable legal foundation. The attorney must ponder how and what to appraise leaving the appraiser only the problem of appraising it.

# Proof of Value in Eminent Domain: Air Space

JOSEPH KUEHNLE, Vice-President, Walter R. Kuehnle and Co., Chicago

•IN the last few years air rights projects and air tunnels have created millions and billions of dollars in new economic development all over the country, just as they have saved millions of dollars in highway land acquisition costs. Great as this past activity has been, it is only a forecast of what the future offers. Our cities are going to grow much larger and become much more densely populated. Land will become scarcer, and, with increasing scarcity, land—particularly in urban areas—will be increasingly valuable. This prospect is the motivating force behind the great interest in air rights at the present time. Greater use of air rights and air tunnels, both above-the-ground and subsurface, will be a necessity in minimizing land acquisition costs, and perhaps even in the basic matter of finding space for further development of the urban center.

With this activity in prospect, the realtor and appraiser, the attorney and the engineer, and the agencies which are interested in acquiring land for various purposes, must be familiar with the basic concept of air rights. Tax assessors also need to become familiar with this concept, as do the financier and economist. In discussing why potential air rights and tunnel locations will be in demand, and how this may concern land acquisition in the highway programs, I would like to first indicate some of the history of the development and use of air rights. Next I will describe their nature, ownership and special features, and a formula for their appraisal. And finally, I have some comments on the prospects for their future use.

## DEVELOPMENT AND USE OF AIR RIGHTS: HISTORICAL PERSPECTIVE

In 1965, A. M. Hill, Director of the Bureau of Right of Way and Land in Los Angeles, California, became greatly interested in air rights and made a comprehensive study which showed that air rights over and under railroad rights-of-way, streets and highways were being utilized in most major cities of the United States. The range of uses of these facilities included

office buildings	hospitals
hotels	heliports
auditoriums	department stores
mercantile buildings	apartments
industrial plants	parks and playgrounds
parking lots	

Many of the developments on air rights were large and important projects, involving investments of many millions of dollars. In addition, tunnel easements, saving millions on highway acquisition cost, had been acquired and were in use.

Most instances of air space use involved acquisitions of air rights separate from the land. In some cases, however, there was acquisition of land with agreement to keep it vacant. Typically this occurred where adjoining property might need to have light and air space around it. Thus the developer of land might wish to acquire adjoining land without the air rights, and thereafter use this factor in his formula for height planning. By varying the factors of floor area and ground area, he might work



out a plan for building higher than he would ordinarily be able to on a particular piece of land. All major cities have their own formulas for granting high-rise building permits. Under the technical formula required by the city his objective is to reduce his land acquisition and construction costs to the minimum while still staying within the terms of the formula.

In Detroit, the city was helped when the expressways were brought under its famous new convention facility, Cobo Hall. In Chicago, when the Congress Street Post Office was built, it was designed so that tunnels could be used to run an expressway through the building. Other buildings built with attention to the use of air rights include the Merchandise Mart and Prudential Building in Chicago. In Boston, where a shortage of land is being experienced, the city acquired 30 acres of air space over railroads and turnpikes and is planning a project twice the size of Rockefeller, including a 52-story office building, banks, an auditorium, hotel, shops, and almost 10 acres of parking. In New York, high-rise apartment buildings have been built on air rights in many places, but most recently over the depressed expressway approach to the George Washington Bridge. The buildings are built on steel platforms extending across the depressed expressway. Cincinnati has acquired highway tunnel access under valuable property in the city's central business district, and by purchasing only the tunnel space and not acquiring the surface space above, it has greatly minimized the cost of this route. In Washington, D. C., the General Services Administration successfully used the aesthetic approach to argue in favor of a proposal to build a \$48 million building for the Department of Labor over the entrance to an underground freeway "hiding a gaping gulch with traffic pouring through it."

With this background of air space use, we must anticipate increased pressure for land development, and a resultant increasing demand for air space and subsurface tunnel rights in all major metropolitan areas. Chicago recently proposed building a freeway over 20 miles of railroad rights-of-way. This freeway formerly was suggested for a route that would go through some residential areas, and this proposal had brought delegations protesting to the mayor and council demanding that another route be chosen. Practically every alternative surface route had the same consequences, so the mayor began to look with some interest at the proposal for using the space above the railroad tracks.

This proposal illustrates another factor which enters into the use of air space, namely, the cost factor. In this particular instance, the 25 miles of elevated expressway was estimated at \$500 million, including land and air space acquisition and highway construction. This is just about \$25 million per mile, and even in this day of expensive highways this figure would seem to present a financial problem that could be overcome only by heavy contributions from the Federal Government matching proportionately heavy contributions from local government. To date, the financial obstacles have proved to be decisive in delaying approval of this project; but the sheer boldness of even suggesting it as an idea that is within the reach of engineering technology is significant. Perhaps such ideas as this will become common in the future, whereas today such a project would have to be solved with construction on the ground and relocation of the residents who are displaced.

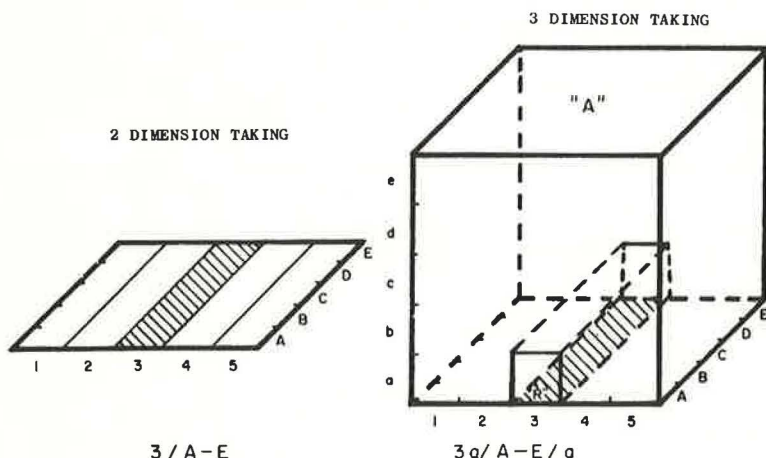
At the present time, Chicago also has an elaborate system of underground tunnels and walkways between downtown area buildings and stations. There are plans to expand it vastly. But even today, one can use tunnels beneath the Loop area to come and go from all of the major office buildings without ever coming up to the surface. One of the ramifications of this planned system is to have a circulating subway transit system to get the people from the suburban railroad stations and the centers of parking to their downtown offices and stores. This would naturally eliminate a lot of surface traffic.

It is my understanding that the city of Los Angeles has acquired the state's rights to areas of air space over the freeways, and is contemplating the use of this space for parking and other facilities. It is also planning a subway under Wilshire Boulevard, and a 2-mile long space city over the planned Beverly Hills Freeway. These ideas are occurring with regularity among those who are planning our major urban areas of the future.

Sacramento plans to lease the space above an 8-level parking structure for 17 additional stores to serve as hotel accommodations. Pittsburgh already has done something similar to this over an existing structure without bothering to demolish the older structure when it appeared too valuable to be destroyed. During the preparation of this project, I was called in several times to advise on the unusual aspects of the case, and we had to go beyond the usual concepts of air rights appraisal in this particular problem. Even in Springfield, Illinois—a city of 120,000 people—there is an instance where a savings and loan company built a building of 10 stories over an existing structure of 8 stories entirely in air space leased from the owners of the lower building.

### NATURE, OWNERSHIP AND VALUATION OF AIR RIGHTS

What is an air right? It can be described as a vertical subdivision of a property in contrast to the traditional and familiar horizontal subdivision of land on a plane surface. It can be illustrated graphically (Fig. 1). In the case of horizontal subdivision, the property is divided up in parts according to their frontage and their depth—a two-dimensional concept. The concept of air rights divides an existing site (which already has been subdivided on the two-dimensional concept) into layers, like a layer cake. It describes these layers or levels in relation to some fixed point, such as "city datum." Thus, for example, one may acquire all of the air rights beginning from a point 23 feet above city datum, and extending indefinitely to as far as the reasonable use concept



NOTE:  
SPACE MODULES OF 3 DIMENSION SUBDIVISION MAY BE VARIED TO ACCOMMODATE  
MOST EFFICIENT DESIGN OF AIR-RIGHTS IMPROVEMENT.

#### Formula

$$V - (X + Y) - I = A \quad \dots \quad V - A = R$$

V = Value of the land before taking 3 dimensional interest.

X = Economic value lost due to reduction of functional utility (net income) in modifying building for construction on the "A" interest.

Y = Additional cost of constructing the building under the terms of the conveyances creating the "A" and "R" interests.

I = Interest on investment for the additional period of construction as a result of the divided vertical interests.

A = Value of air-rights after taking of 3 dimensional interest.

R = Remainder 3 dimensional interest.

Figure 1. Valuation of vertical highway tunnel easements for highway right-of-way.



permits. In this regard, the "reasonable use concept" is today favored over the old common law notion that one's property right extended indefinitely upward without limits. In the theory of the common law a property owner's air rights extended upward without regard to the practical extent to which the property owner reasonably could use the air space according to the highest and best use of his property. Today, however, it is more usual to see air space conveyed between two measurable points which are described in their relation to a known point, such as city datum.

Such a layer of air space, if you want to visualize it as one of the possible vertical subdivisions, is designated as an "air lot." With respect to any given parcel of land we might have several lots at various levels above the surface. A sophisticated instrument for the creation of an air rights interest might, therefore, have to include a number of elements. It would have the "air lot"—the layer—as described in terms of a certain point above the city datum. It might possibly also have to have a freehold interest for the boiler-room and the elevator shafts, which probably would require digging down to solid rock or earth. It also would probably have space or lots reserved for columns to support the deck, and subsurface structures, such as caissons, to go below the surface.

There are several types of title to air rights and tunnel rights. Interests of this sort are usually created either by lease or fee title, and in most cases the lease or fee title describes this air lot, together with the various fee areas for supporting columns, and perhaps caissons or cross-members. These latter would also be described as lots, and would be transferred either by lease or by fee title. Less common is the practice of selling or leasing the property with reservation of easements for specific surface uses. There are certain disadvantages in leasing, as far as financing is concerned. Therefore, in many cases the best method is to sell the air rights and lots for supporting structures in fee. Occasionally this may not be feasible, as where one is dealing with the air space over railroads, which the railroads may not sell, but be willing to lease. What method is best? The one that best meets the needs of the particular situation.

There is going to be a great demand for well-located air space sites due to the impact of population growth in our cities. This demand, and the requirements of zoning which require that more land be devoted to buildings for floor area, parking space, auxiliary features, height restrictions and buffer space around the edges of the built-up areas, all have to be considered in determining how a site is to be developed. Cities like Chicago, New York, Los Angeles and San Francisco just do not have new and unused space available in the central city any more. So, the city must often engage in an extensive urban renewal program in which older sections of the cities are torn down to make space. This is frequently expensive, involving from \$2 to \$10 per square foot for acquisition cost. It is not unusual to find land in the central business district ranging from \$10 to \$50 a square foot. In such cases the use of air rights in connection with urban renewal is economically justified. When land is worth only 50 cents a square foot the extra cost of building in air space is not justified.

#### THE DEMAND FOR AIR SPACE

The 15,000 to 30,000 square foot sites, which were typical in the central city areas before World War II, are no longer suitable. Directly east of Chicago's central business area are 70 acres of Illinois Central Railroad tracks. Title to the air rights in the space over these tracks was recently cleared after a lawsuit which took 2 years. In this case the state of Illinois and city of Chicago challenged the railroad's ownership of these air rights, claiming that the Illinois Central had the right to use this property for railroad purposes only, and this did not give the railroad the right to build office buildings and apartments over the tracks. The issue became one of interpreting the railroad's original charter, and the Illinois supreme court ruled that it was within the railroad's charter powers to develop the air rights as they desired. Now that this has been settled, 70 acres of land in the vicinity of the Prudential Building (which is also built on air rights) is not available for air rights development, and should be extremely interesting to watch in the future.



Another example of what is happening in Chicago's central business district is the Field Building. In the 1930's this building was built on one half of a typical downtown block, about 60,000 square feet. This was considered to be a very unusual site in its day, with frontage on three streets and an alley. The Prudential Building was built in 1960 in air space over the Illinois Central Railroad and occupies a site of 170,000 square feet, or the equivalent of a block and a half in downtown Chicago. Interestingly enough, however, both the Field Building and the Prudential Building have about the same amount of rentable space inside.

The First National Bank in Chicago, which occupied a half block, needed the other half of the block on which it was located. In order to obtain this additional 60,000 square feet, the bank had to acquire, among other things, a 40-story hotel (the old Morrison Hotel), and pay approximately \$30 per square foot of land area to wreck it. This is after deduction of salvage, and is due in part to the need for extreme caution when carrying on demolition of buildings in the heart of a central business district.

It is no wonder, then, that developers are beginning to look with interest at air rights sites, and that this interest is being recognized by highway planners. Rex Whitton, the former Federal Highway Administrator, recently made the proposal that a public corporation or agency undertake to acquire entire blocks in the route of a freeway, and then dispose of the land by selling the air tunnel space to the highway department and the air rights over the tunnel for other types of development. This, of course, would be attractive mainly in areas where there was already a high degree of land development in order to justify the costs involved.

### THE VALUATION OF AIR SPACE

Past studies of the division of air rights and railroad rights-of-way have indicated in very broad terms from 75 to 85 percent of the total base value in the air rights. This would indicate that access through valuable central areas might be acquired, say for highways, for 20 to 25 percent of basic land costs. As the land becomes more valuable, the land cost percentage will probably rise. Like so many complex problems, however, this is a rule of thumb that applies in many cases, but may not apply to any particular case. Accordingly, a formula has been developed. And, as with many other complicated problems, the principle involved in air rights and access tunnel rights is quite simple. It may be expressed in the principle of the value of the land before and after the taking of the vertical access layer. This comparison is based on a consideration of the basic facts of added cost in building in the air space, and loss in economic value in constructing an improvement built in the air space rather than one on the ground. This latter is a factor reflecting the lesser utility of an air space structure as compared with a ground level structure. A simple illustration of this is shown in Figure 1 and its accompanying explanation.

In the formula given, V is the basic value of the land free and clear of railroad tracks or anything else. The X-factor is the economic value which is lost due to reduction of functional utility (net income) in modifying the building for construction. For instance, maybe the building does not have the utility rooms that normally go into a basement, and these have to be transferred to one of the upper floors at the loss of rental use of this space. This would reduce the net income of the building as compared with a building that is constructed on the surface.

The Y-factor refers to the added cost of construction of the building in the air space interest. The Merchandise Mart in Chicago used \$500,000 more in steel than would have been the case if it had been built on the ground. Also, at the time this building was built the railway beneath it had not been electrified, and so a special smoke abatement system was installed at the added cost of \$100,000.

The I-factor refers to the additional interest which must be paid for funding projects built on air rights. Usually such projects take a little more time to build than ones that are built on the ground, so the bank's money will be tied up in the project for a longer period of construction.

The factors X, Y and I are all deducted from the basic value of the land to compute the value of the air rights. To determine the value of the remainder of the land after



taking the air rights, one simply deducts A (air rights) from V (value of the land before taking).

That sounds simple enough, but determination of some of these costs with any degree of precision may become a difficult exercise. All of the problems which are present in a normal appraisal analysis are present in an air space appraisal, plus the additional ones I have just indicated. Some of these questions may be illustrated by the following example.

Assume the value of the land in question is placed at \$25 per sq ft. For the 60,000 sq ft this would be \$1.5 million.

Assume also that the architects and engineers determine on the basis of bidding that it is going to cost \$275,000 more to build this building on air rights than on the surface, due to the cost of the deck and additional construction. As a result of this analysis, it is further concluded that this building will produce \$20,000 per year less rent than a building built on the ground on a site which could be bought for, say, \$25 per sq ft. The additional time of construction will be about 3 months, and credit financing can be arranged at 6 percent interest. In capitalizing the value of the property, we use an overall capitalization rate of 8 percent.

Therefore, from this \$1,500,000 which is the base value of our 60,000 sq ft of land, we determine the value of the air rights by first taking off the \$275,000 additional construction cost, then the capitalized value of \$20,000, divided by 8 percent overall rate (the capitalization of that rent loss), or \$250,000. One-quarter of a year's interest on the building investment would also be deducted. If we have estimated the building to be worth \$5 million, this delay will cost us 3 months' interest, or \$75,000.

Deducting those items from the base land value, that leaves \$900,000, or approximately 60 percent of \$1.5 million. In this hypothetical case, the determination came out at 60 percent, but the figures could come out at anywhere up to 90 percent by varying any of the factors mentioned. On the basis of experience, there has been a tendency for the figures to hit somewhere in the general area of 25 percent as a sort of benchmark. If it departs from that figure, one should take another look at it to see why.

Because these additional construction costs affect the value of the air rights, it is important to provide for them when planning a highway improvement. Those who are familiar with urban renewal know that it is possible for restrictions on a piece of land to affect the value through limiting its highest and best use. A good example of that is in the Carl Sandburg Urban Renewal Project in Chicago where the zoning required that each apartment have 300 sq ft of land. This project was on the edge of an area where land was selling at that time for \$20 to \$30 per sq ft—now it would be up to \$40 or \$50—for multi-story apartment use. This land sold for about \$9 per sq ft because of this restriction, and the effect of this zoning brought the price of land for each apartment up to about \$3,000. In the area to the east, where the zoning was a high-type residential category, developers only had to have 100 to 150 sq ft per apartment, and could buy land for two or three apartments with the amount needed for one in the urban renewal project area.

The same result follows where zoning imposed height restrictions on buildings. So, if landowners intend to take or reserve air tunnel rights over a piece of land, it is very important that they do not overload the land with restrictions in an effort to protect against certain conditions which they feel are unwise. Naturally, all the rights which are necessary to protect the highway must be preserved, but unnecessary limitations can be a dangerous thing, and can hurt the value of both the land and the air space. Also in designing the improvement—in such things as the spans, the columns, and spacing of the columns—is its effect on cost of construction. Good design will usually minimize the cost of the air rights.

## CITIES OF THE FUTURE

We have talked about the history of air rights, and the valuation of air rights, in a framework of the past and the immediate future growth of our urban areas. The ultimate potential growth of our great urban areas, however, is less easy to visualize.



One can comprehend something of what is possible by noting that in 1960 there were 100 million Americans—56 percent of the population—living in five great urban regions and 11 smaller ones. These regions covered about 7 percent of the country's total land area. By the year 2000, it is estimated that 240 million Americans, or close to 80 percent of the population, will live in three huge urban regions—megalopolises—and 19 smaller metropolitan areas. These will be in the east, the midwest and California.

Envisioning this development, there will be vast problems of water supply, pollution control, transportation, preservation of amenities, and above all else, the problem of efficient utilization of space. This concentration of population implies a great shortage of land, which obviously will have to be met by making more use of the air space. It is hard to realize that in 1903 New York's Park Avenue was just a railroad track right-of-way with the cross streets dead ending on each side. But New York was one of the first places to face this space shortage, and it solved its problem by building up over the tracks, and designing the buildings so that the new "street level" was at the height of the viaduct. Chicago did the same thing when it double-decked Wacker Drive, and moved the building entrances up to the upper level. Now many cities are looking at their central business districts with this idea in mind simply because they are running out of space on the land itself. Indeed, the new Pan Am Building in New York is bolted onto the deck of a structure which itself is built on air rights. Thus, New York is going into its "second generation" of buildings built in air space.

Population expansion is thus going to bring some serious urban problems which the use of air rights and tunnels will help solve. Most people born between the turn of the century and the 1930's have seen the American city evolve from neighborly communities, each with some identity of its own, to big anonymous collections of buildings, streets and people. Many can remember the streetcar, or even the horse car, moving along streets that were relatively quiet and spacious. But, as the automobile took over the streets, this atmosphere changed, and the demand for street space seemed insatiable. Moreover, streets generally lost their cohesive function in the community, and had the effect of breaking up neighborhoods by functioning as barriers rather than links. Much of the present urban mobility is the result of people restlessly seeking to find a neighborhood atmosphere in which to live. But, it is a self-defeating process since the shifts in population tend to carry with them the same dependence on automobile transportation which changes the community's character.

Recently the Greek economist and planner, Constantinos Doxiadas, visualized how the earth would look to a spaceman from Mars observing us from his flying saucer. Upon returning home, he suggested, they might give the following description of the Earth People:

The Earthmen are creatures about 20 feet long, about 5 feet high and wide. They appear to be built of steel with aluminum fittings. They have two big eyes which are illuminated at night; and they roll on round legs at several tens of miles per hour.

Doxiadas properly questions whether the city in which man is stopped by red lights, in which children are not free to roam and play where they please, where the air is rendered impure by automobile exhaust can properly be called a City of Man, even though man has created it. He suggests that a city dominated by the automobile is not the City of Man. However, although the automobile is in danger of throttling the cities in a noose of concrete and polluted air, we know that automobiles are necessary and must be accommodated for the foreseeable future. How to reach an accommodation on this point is one of our principal problems in America today.

What does this mean for us in designing the cities of the future? Perhaps the future Cities of Man, "deepways" or tunnels under the surface may be cheaper than trying to rearrange the buildings on the surface. High-speed express routes can act as buffers and barriers to subdivide the major segments of the urban area into units which can achieve some better form of community life. In these communities, of, say, 50,000 residents, surface street traffic as we now know it would be drastically reduced in



favor of other methods of local transportation. When we consider that in 1810 the population of the United States was about 7,250,000, and grew to 31 million in 1860, to 92 million in 1910, to 196 million in 1967, and it is estimated that it will reach 300 to 400 million by the year 2000, we can appreciate the size of our problem regarding means of transportation.

There is every indication that new means of automotive transportation will have to be developed before the air pollution danger is solved. But urgent as this may be, there is still the problem of a shortage of street space. So in building highways and considering the use of air space we must think of answers that are far ahead of what we have seen up to the present. In Chicago, for example, I recently saw a huge abrasive cutting machine, called "the mole," which will attempt to drive two 15-ft sewer tunnels, each 4 miles long, through solid rock 150 ft below the surface of the earth. The schedule for this work is one year, so the time when extensive subsurface construction may be economically feasible may be close at hand.

If we are going to meet the challenge of the future, it is obvious that we must understand not only all of our many present problems of urban development, but also the various uses of the tunnel principle in dealing with some of these problems, whether we apply it underground or in the air space over the ground.

# Appraisal Testimony: A View From the Witness Stand

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•IT is not often that appraisal witness has the opportunity to state his opinion to a group of attorneys without them being merely in response to questions of an advocate, being objected to by other advocates, or being ruled inadmissible by a judge.

I would like to share with you some of the experiences of other members of our appraisal staff, as well as my own, in condemnation cases. We make it a practice in our company to spend some time with our appraisers before they testify in court. Our instructions to them can be stated very briefly: (a) be thoroughly prepared, and (b) tell the truth.

Being well-prepared for a court case includes many things. The witness should know as much, or more, about the property in question as anyone in the courtroom, including the owner. I have found that memorizing minute details of the property can be very effective. The jury or commission hearing a case seem to think that a witness who remembers the color of the ceramic tile in the bathroom or the brand name of the furnace and water heater must have paid just as much attention to all of his appraisal, therefore, he must have made a good appraisal.

Being well-prepared means having enough conferences with the attorney before the trial so that the appraiser knows exactly what questions are going to be asked of him in direct testimony and the attorney knows exactly what the answers are going to be to each of his questions. Nothing is more damaging to the case than to have the witness not understand what the attorney means by a question, unless it is an answer by a witness that is totally unexpected by his own attorney. For this reason, I am a firm believer in writing out the questions and answers that will be used in direct testimony.

Being well-prepared also means having enough conferences with the attorney that he knows of any weaknesses as well as the strong points of the appraisal. By the same token, it is prudent to try to anticipate the weakness or strength of the opposition's testimony. Frequently, it is better to bring out in direct testimony a weakness in an appraisal than to wait for the opposition to find it on cross-examination and then make it the main issue of the trial.

Frequently, we get requests from attorneys who are not familiar with our methods of preparation for court testimony, informing us that a court case is scheduled to be tried at 9:30 on Monday morning and "Can we have your appraiser at the courthouse at 9 o'clock for a conference?" We find it difficult to honor such requests, not only because our schedules are planned for several weeks in advance, but because we feel we would not be providing our client with the highest professional service, and would be doing the court an injustice by testifying without adequate preparation. Gentlemen, if you want me to testify for you, give me enough time to prepare. Fred Hudson, an attorney, said, "I have never lost a case through over-preparation."

The second word of advice to the appraisal witness, and by no means of lesser importance than preparation, is to tell the truth. This may seem an unnecessary instruction but nothing will alienate a jury quicker than a witness who strays from the truth for the obvious benefit of the client who is paying his fee. I have found that when an



error is discovered in my testimony, it is much better to admit the mistake in a forthright manner than to try to cover up. If I admit the error, there is little the opposition can do, but if I try to cover up, the other attorney may have a field day.

In presenting testimony, I have found it important to ascertain the degree of sophistication of the jury or commission that is hearing a case, and to plan my testimony to talk up to them rather than down to them. For example, some condemnation commissions are composed of people who are thoroughly familiar with the appraisal process. It would be a mistake to spend a lot of time explaining the appraisal approaches to them. With juries, the opposite may be true. We have testified in a number of cases where such terms as Hoskold's formula, the Inwood tables, the Elwood Method of Capitalization and other language of appraisers has entered into the testimony. While there is nothing wrong with these terms, a country jury would not have the foggiest idea what the appraiser was talking about, and probably would care less.

To overcome the tendency to talk over the heads of the jury a good appraisal witness develops explanations of technical terms or methods that are readily understood by the layman. In a case in El Paso, Texas, an important item of consideration in estimating the net income was the matter of reserves for replacement. To explain this term to the jury, our witness used the illustration of his mother keeping several cookie jars on the pantry shelf in which she periodically, but regularly, set aside a small amount of cash each week in order to save up enough to replace some household item such as a refrigerator. The women on the jury knew what he was talking about. The proper use of this schoolroom technique not only is effective in holding the jury's attention but it guides them into the witnesses' line of reasoning and builds up a closer bond between the witness and jury.

This brings up another question. Is a jury, a commission, or a judge best for trying a condemnation case? As an appraiser, I personally believe that a jury is competent to hear cases involving farms, homes or other uncomplicated properties. However, for those cases concerning highly technical valuation principles which are frequently encountered in the condemnation of large industrial, commercial or institutional properties, I believe a competent commission or a judge will produce the fairest decision for all concerned.

There is an old adage that condemnors usually prefer a judge or commission, whereas the condemnees' prefer a jury. However, I know everyone who has had condemnation trial experience has seen some extreme upsets in this preference, particularly on highly technical cases which were tried before a jury.

As appraisal witnesses, we like to think (even though this may be naive) that the court wants to hear all the pertinent facts about the property being condemned and all the factors that should be taken into consideration in expressing an opinion of value. Frequently, however, all of the facts are not presented to the court for one of several reasons.

We know as appraisers that when we accept an assignment to testify as an expert witness that our qualifications are going to be given careful scrutiny by the opposing attorney. There is nothing wrong with this, but there are some archaic rules about qualifications which still come up. For example, we have on our staff a man who is not only an engineer with over 25 years of experience appraising mineral deposits, mostly gravel and stone, but is also a well-educated geologist. He spent about a month preparing an appraisal of a stone quarry and was called to testify in court. As soon as he got on the witness stand, and started giving qualifications, the opposing attorney asked him if he had ever bought or sold real estate in the area involved. The witness patiently tried to explain that he was not a real estate salesman but was an engineer who had devoted most of his business career to the valuation of mineral deposits. The judge ruled that inasmuch as he had not bought and sold real estate in the county in question, he was not qualified to testify to the value of this highly technical and complex property involving about \$1,000,000 worth of rock deposits. However, a local real estate salesman whose principal qualification consisted of 10 years' experience selling farms was permitted to testify, in that court, on the value of rock deposits.



Another problem in getting all the facts before the court involves the admissibility of comparable sales. Although it varies in practically every court, the application of the hearsay rule to discussion of comparable sales is sometimes very frustrating. For instance, in Michigan the court can listen to evidence of comparable sales for the opinion of the expert appraisal witness, but it cannot hear evidence of sales as an indication of the value of a property. In one case in Michigan, I was testifying for the state in condemnation action involving some residential properties. The attorney trying the case for the state would not let me testify to the facts of the sales that I had considered in making my appraisal. Without being able to go into the comparability of the sales, my testimony was useless as far as helping the commission reach a decision. I might just as well have stated I made a good appraisal and my conclusion was "x" number of dollars.

In a Georgia case, the judge ruled that our appraiser could not mention sales he had considered in making his valuation if he had not actually based his valuation on them. In this case, the appraiser had derived some indications of value from a number of sales, but since his conclusion was not based directly on any of the sales, he could not testify to any of the sales. I have found that, for certain properties, it is almost impossible to find sales that are directly comparable and that it may be necessary to gather indications of value from the sales that have taken place even though they may not be as comparable as I would like. Of course, this can be carried beyond reasonableness. I reviewed an appraisal recently that involved a chicken hatchery which was being condemned. Two sales were used by the appraiser in his market data approach: one for \$10,000 and the other for \$16,000. After making adjustments for size, location, etc., his conclusion was these sales indicated a market value for the subject property of \$550,000. The ironic thing is the appraiser admitted one of the sales included no real estate but was only personal property such as trucks and incubators.

You may have encountered judges who rule that all comparable sales must have taken place before the date of expropriation. We testified in a condemnation case in Texas which was not tried until almost two years after the date of expropriation. The property was an insecticide plant, which is a highly specialized type of property. A thorough search of the records revealed one sale, that of an egg drying plant, which took place just two days after the date of expropriation of the subject property. The sale plant was almost identical to the subject property in that both had drying chambers and other similar special purpose features. However, the court ruled that the appraiser could only testify to sales which had occurred before the date of the taking.

I have been in some courts that object to the admission of the sale of the subject property as evidence of its market value. It would seem to me that if the sale were an arm's length transaction it is the best possible comparable provided the date of sale is not too remote. To be considered comparable, any sale should meet at least the following four-way test:

1. It must be comparable as to time.
2. It must be comparable as to location.
3. It must be comparable as to character of property.
4. It must be an open, arm's length sale.

In order to pass judgment on the comparability of the sale, the appraiser must know as much about the sale as he does about the property he is appraising. The above rules are fairly well-known, but I am sure that many will recall a great many sales which got into evidence that do not meet the above specifications.

One other restriction on the appraisal witnesses' testimony that hinders the court from hearing all of the facts concerns "highest and best use." Some courts have ruled that the only use the appraiser can testify to is the legal use permitted by the zoning ordinance. This might be a proper ruling in those areas where it is almost impossible to get a zoning variance, but in those areas where it is about as easy to get the zoning changed as it is for a woman to change her mind, it appears to me that it would be more reasonable to listen to evidence as to the probability of getting the zoning changed. Maybe the appraiser should testify to two values: (a) the value of the property under existing zoning, and (b) the value of the property taking into consideration the possibility



of having the property rezoned. Then it would be up to the court to decide, after hearing the evidence, whether it would be reasonable to assume the property could be rezoned.

The practice of some attorneys to ask their appraisal witness to sit with them at the lawyers' table in the courtroom and advise them, particularly on technical matters, with respect to cross-examination of opposing witnesses has always bothered me. Of course, in many courts the witnesses are not permitted to be in court when other witnesses are testifying. However, in those courts where this rule does not apply, I believe the image of an unbiased expert witness is better preserved when the appraiser disassociates himself from his attorney in the court room. If you think you will need technical appraisal help in trying your case, it would be better to hire another representative to sit with you at your table.

The 1956 Federal Aid Highway Act, under which the Interstate Highway program is being completed, caused many problems in eminent domain. Many states had vague, indefinite statutes governing the exercise of eminent domain. Many of these statutes were designed for horse-and-buggy roads, and were hardly applicable to the modern limited-access freeways and expressways. In many states the question of compensability for certain items has been left to case law rather than to statute law. As a result it is almost impossible to determine what is compensable and what is not. The experience of our appraisers in making appraisals in many states for condemnation purposes brings me to the conclusion that it is time for the states to take a close look at their condemnation statutes if they have not already done so.

An example of what can be done along this line is what has been done in Wisconsin. Several years ago, the Governor asked the legislature to prepare recommendations for revision of its condemnation law, and he appointed a committee consisting of two judges, the attorney general, a public utility condemnor, two attorneys who specialized in condemnees' cases, a State Farm Bureau representative and a real estate appraiser. A vice president of our company was appointed to this committee as the appraisers' representative. The committee met regularly for nearly a year working up recommended legislation. The sessions included a number of hearings, which were well-attended by the public, in an effort to learn some of the factors causing problems under the old condemnation law which might be corrected by new legislation.

As a result of these hearings, and over a year's work by this committee, the Wisconsin legislature passed a new condemnation statute which is unique among such statutes in that it provides payment of damages for the following four items:

1. The cost of moving personal property (with certain dollar limitations).
2. The damage caused by loss of favorable financing; for example, a GI who has his home mortgaged under a GI loan at 4 percent interest and finds after his house is expropriated that he must pay 6 percent interest. The difference between the old rate of 4 percent and the new rate of 6 percent interest is now a compensable item of damage.
3. Loss of rentals—the damage caused by the loss of rentals between the time a property is earmarked for condemnation through a relocation order and the time the property is actually taken is now a compensable item of damage.
4. The loss of plans and specifications rendered useless as a result of a taking is now a compensable item of damage; this pertains to actual costs of subdivision plans or building plans which are rendered useless by a taking.

Formerly, it was necessary for the appraiser to estimate the damages and include them in the appraisal report. Now it has become an administrative function of the highway commission and the property owner must show proof of any of these damages.

In addition to these four unique items of damages, Wisconsin also decided that damage resulting from the nature of the public improvement was also compensable. There was an adage that the appraiser should never anticipate the improvement that was going to be put upon property condemned by the state because once the state acquired the property it could do whatever it wanted with it. The appraiser must now take the proposed improvement into consideration in his valuation of the property remaining after the taking.

During the hearings that were held in connection with this revised legislation two problems came up so many times that the committee discussed them at great length and made every effort to solve them.

The first matter concerns damages caused by the cloud of condemnation hanging over a property for a long time. This situation exists particularly in urban areas where the urban renewal agency will earmark a given area for redevelopment and then wait two or three years before actually taking the property. The cloud of condemnation hovers over the area for the intervening period and literally freezes real estate values in the entire area. This same situation occurs when highway programs are announced prematurely and a property is earmarked for condemnation but not taken until several years later. There is one large industrial plant in Milwaukee that has been under this cloud of condemnation for nearly ten years. The public agency is just now getting around to taking the property.

The committee deliberated on the foregoing problem for a long time and finally decided that it could not be corrected legislatively except by providing funds for payment of certain hardship cases. The stumbling block in trying to write such legislation presented itself in determining what act constituted the intent of taking. In order to make such legislation effective it would have to be tied into specific action on a specific date, and usually the first such action is the actual filing of the relocation order or the notice of condemnation. All preliminary announcements and negotiations have no legal status.

The second matter which the committee tried to correct legislatively was the problem of the lessee's interest in the condemnation of a leased property. Some states recognize the lessee's interest in a property to a certain extent but, unfortunately, in most states the property must be appraised as if it is free and clear of any encumbrances; and the lessee must make his settlement with the owner of record, although as lessee he has no place at the bargaining table. I feel that the lessee should be represented and included in the negotiations and at the bargaining table, particularly in those cases where the lessee's interest actually exceeds the lessor's interest.

I do not know if lawyers can work out specific laws in their states to solve these problems, but if they can it will make the appraiser's job that much easier. Maybe I have become too cynical about due process of law as it applies to condemnation cases but I am reminded of an answer by an assistant attorney general in Michigan. When I asked him if he thought just compensation was arrived at through due process of law, he said, "Invariably—but they never stop there."