

Contractor/Subcontractor Flow-Downs and Negotiation of Subcontractor Terms and Conditions



Mike Rizzo
Gail Zirkelbach

McKenna Long & Aldridge

What is a Subcontract?

- No definition in FAR Part 2
- A contract entered into by a subcontractor to furnish supplies or services for performance of a prime contract or subcontract. It includes, but is not limited to, purchase orders and changes and modifications to purchase orders. FAR 44.101
- “Subcontractor” means any supplier, distributor, vendor, or firm that furnishes supplies to or for a prime contractor or another subcontractor. FAR 44.101



What is a Flow-Down Provision?

- Clauses from a prime contract that get incorporated into a subcontract
 - ❖ Subcontract clauses “flow down” responsibilities of prime contractor to subcontractor
 - ❖ Often triggered by subcontract dollar value threshold or a desire to mitigate risk
- Methods of incorporation: FAR 52.102 provides guidance for USG that applies to prime/sub flow-downs:
 - ❖ Clauses requiring verbatim incorporation -- MANDATORY
 - ❖ Clauses that must be incorporated in substance
 - ❖ Clauses that are silent on incorporation

Mandatory Flow-Downs for Commercial Items

➤ **Contractor Code of Business Ethics and Conduct, FAR 52.203-13**

- ❖ Contractor must have written code of business ethics and conduct, an ongoing business awareness and compliance program, and an internal control system
- ❖ Trigger threshold: subcontract with value in excess of \$5,000,000 and performance period of more than 120 days

➤ **Whistleblower Protections Under the American Recovery and Reinvestment Act of 2009, FAR 52.203-15**

- ❖ Contractor must post notice of employee rights and remedies for whistleblower protection

➤ **Utilization of Small Business Concerns, FAR 52.219-8**

- ❖ Contractor agrees to carry out Government's policy of encouraging participation of small business concerns in performing contracts by any Federal agency

Mandatory Flow-Downs for Commercial Items (cont' d)

➤ **Equal Opportunity, FAR 55.222-26**

- ❖ Prohibits discrimination against any employee or applicant on the basis of race, color, religion, sex, or national origin and requires employers to make an affirmative action plan to ensure compliance
- ❖ Trigger threshold: \$10,000

➤ **Equal Opportunity for Veterans, FAR 52.222-35**

- ❖ Trigger threshold: \$100,000

➤ **Affirmative Action for Workers with Disabilities, FAR 52.222-36**

- ❖ Trigger threshold: \$15,000

Mandatory Flow-Downs for Commercial Items (cont' d)

➤ Notification of Employee Rights Under the National Labor Relations Act, FAR 52.222-40

- ❖ Requires employers to conspicuously post employees' right under the National Labor Relations Act
- ❖ Trigger threshold: \$10,000

➤ Combat Trafficking in Persons, FAR 52.222-50

➤ Preference for Privately Owned U.S.-Flag Commercial Vessels, FAR 52.247-64

- ❖ Requires use of a U.S. flagged commercial vessel for shipment of at least 50% of gross tonnage involved under the contract whenever transporting via ocean vessels

Mandatory Flow-Downs for Noncommercial Items

- Same Mandatory Flow-Downs for Commercial Items
- **Anti-Kickback Procedures, FAR 52.203-7**
 - ❖ Prohibits contractors from providing any kickback or soliciting or attempting to accept any kickback
 - ❖ Trigger threshold: \$150,000
- **Limitation on Payments to Influence Certain Federal Transactions, FAR 52.203-12**
 - ❖ Prohibits contractors from using appropriated funds to pay any person for influencing or attempting to influence an officer or employee of any agency, a Member of Congress, an officer or employee of Congress, or an employee of a Member of Congress in connection with the award of the contract
 - ❖ Trigger threshold: \$150,000

Mandatory Flow-Downs for Noncommercial Items

- **Audit and Records—Negotiation, FAR 52.215-2**
 - ❖ Applies to subcontracts that exceed the simplified acquisition threshold, and are cost-reimbursement, time-and-materials, labor-hour, or price-redeterminable types for which cost and pricing data are required

- **Patent Rights—Ownership by the Contractor, FAR 52-227-11**
 - ❖ Included in subcontracts for experimental, developmental, or research work
 - ❖ Subcontractor has rights and obligations of contractor in clause; contractor shall not obtain subcontractor's subject inventions

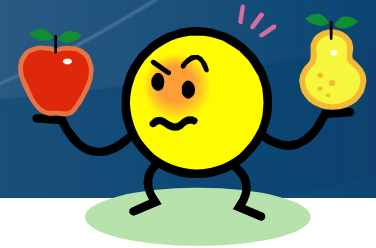
Non-Mandatory Clauses Prime Contractors Should Consider Flowing Down:

- **Termination for Convenience Clause (FAR Part 49)**
 - ❖ Allows Prime Contractor to terminate the subcontract should the Government terminate the prime contract
- **Changes Clause (FAR Part 43)**
 - ❖ Allows Prime Contractor to make changes to subcontract requirements should the Government make changes to the prime's requirements
- **Definitions Clause (FAR Part 2)**
 - ❖ Ensures that a standard set of definition is applicable
- **Protest After Award Clause (FAR Part 33)**
 - ❖ Allows Prime Contractor to issue stop work order to the subcontractor
- **Disputes Clause (FAR Part 33)**
 - ❖ Puts subcontractor on notice of disputes process, including the requirement to submit a certification of a claim



Subcontractors Pay Close Attention:

- Know which flow-downs are mandatory; don't waste your time trying to negotiate those!
- Figure out which non-mandatory clauses are necessary to mitigate risk (termination, changes, etc.) and which place an unnecessary burden on the subcontractor
- If you are a sub: beware of language stating that all provisions applicable to the prime apply to the subcontractor if you do not get a listing of those provisions
- **REMEMBER:** For non-mandatory clauses, contractors and subcontractors can use the FAR or UCC principles to negotiate the contract terms!



FAR v. UCC: Three Part Comparison

- Uniform Commercial Code
 - ❖ Contractual “presumptions” applicable to commercial transactions between merchants
 - ❖ Party-neutral
- Federal Acquisition Regulation
 - ❖ Largely mandatory terms and conditions appropriate for contracts between a private contractor and the Government
 - ❖ Favors the Government
- FAR Part 12—Government Acquisition of Commercial Items
 - ❖ Acknowledges that typical Government contract methods are not effective for acquisition of commercial items
 - ❖ Middle ground between “Traditional FAR” and UCC

	UCC	FAR	FAR Part 12: Commercial Items
Warranties	<ul style="list-style-type: none"> •2-213: Express Warranties •2-214: Implied Warranty of Merchantability •2-315: Implied Warranty (Fitness for Particular Purpose) 	<ul style="list-style-type: none"> •46.701: All warranties must be express •52.246-17 and -18: Contain warranties for simple and complex items 	<ul style="list-style-type: none"> •52.212-4(o): Warrants Merchantability and Fitness •Accommodates Commercial Tendencies •Negotiable
Title Passage and Risk of Loss	<ul style="list-style-type: none"> •2-401: Title passes when seller completes delivery •2-509: Risk of loss passes on delivery 	<ul style="list-style-type: none"> •46.505(a): Title passes on formal acceptance •46.505(b): Risk of loss upon delivery if FOB origin; upon acceptance if FOB destination 	<ul style="list-style-type: none"> •52.212-4(j) and (n): Both title and risk are negotiable •Fallback position—FAR assumptions
Audit Rights	<ul style="list-style-type: none"> •No coverage 	<ul style="list-style-type: none"> •51.215-2: Audit and Records, Negotiation: •Until 3 years from final payment •Proposal, pricing, and negotiation and performance records •Additional “audit” rights under the inspections clause 	<ul style="list-style-type: none"> •52.212-5(d): If competitive, exceeds simplified threshold and excludes 52.215-2: •Until 3 years from final payment •Access to “directly pertinent” records involving transaction related to the contract
Indemnification/ Limitation of Liability	<ul style="list-style-type: none"> •Allocation of risks entirely negotiable •Avoid “betting the company” 	<ul style="list-style-type: none"> •Subpart 46.8: Contractor relieved of liability if loss or damage occurs after acceptance 	<ul style="list-style-type: none"> •No liability for consequential damages

Limitation of Liability Case Study: The Satellite Manufacturer

FACTS:

“Satellites Are Us” supplies satellites to commercial (television) and Government (weather research) customers.

Satellites Are Us purchases a critical electronic component from “Failure, Inc.” During acceptance testing of the satellites by Satellites Are Us, an electronic component supplied by Failure, Inc. systemically fails. The satellites cannot operate without this electronic component.



Satellites Are Us has identified the following costs:

- Cost to remove the electronic components from the satellites
- Cost to ship the components to Failure, Inc. for investigation
- Cost to investigate the failure
- Cost to repair or re-design the electronic components
- Cost to ship repaired or re-designed components back to Satellites Are Us
- Cost expended by Satellites Are Us to retest the Government and commercial satellites
- Potential damages, including possible liquidated damages, payable to the commercial satellite customers caused by loss of revenue from delayed launch
- Payment to Government customers if satellite contracts are terminated for default; or damages for delayed launch

What does the Satellites Are Us contract say?

Limitation of Liability: “The relief that may be awarded pursuant to any dispute under this contract may not exceed actual, compensatory damages. In no event may special, incidental, consequential or punitive damages be awarded.”

Direct Damages: Not Defined in UCC

UCC § 2-714: Buyer's Damages for Breach

- (1) Where the buyer has accepted goods and given notification (subsection (3) of Section 2-607) he may recover as damages for any non-conformity of tender the loss resulting in the ordinary course of events from the seller's breach as determined in any manner which is reasonable.
- (2) The measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount.
- (3) In a proper case any incidental and consequential damages under the next section may also be covered.

Incidental and Consequential Damages

UCC § 2-715: Buyer's Incidental and Consequential Damages

- (1) Incidental damages resulting from the seller's breach include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.
- (2) Consequential damages resulting from the seller's breach include
 - (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and
 - (b) injury to person or property proximately resulting from any breach of warranty.



Case Law Views:

- Gem Jewelers, Inc. v. Dykman, 553 N.Y.S. 2d 890, 160 A.D. 1069 (1990): proper measure of **direct damages** for defective product shipped from seller to buyer when goods are not regularly traded in open market (custom design display cabinets) is the cost to repair or replace
- Canal Elec. v. Westinghouse Elec., 765 F. Supp. 620 (D. Mass. 1990): seller breached contract to supply conforming rotor blades; contract state “actual, compensatory damages” recoverable, but “special, indirect, incidental and consequential” damages excluded. Cost of repair and of engineering and consulting fees to analyze repair is deemed **compensatory damages** and recoverable; claims for lost profits and loss of use is deemed **consequential damages** and are not recoverable.
- Consol. Data Terminals v. Applied Digital Data Systems, 708 F.2d 385 (9th Cir. 1983) (New York law): in warranty action by computer distributor against manufacturer, contract allows “direct damages” but excludes “consequential damages”; plaintiff recovers difference between value of goods as warranted versus the goods as delivered as **direct damages**. Plaintiff recovers inspecting, shipping, handling and storing the defective units as **incidental damages**, but lost profits were excluded from recovery as **consequential damages**.

Which are recoverable?

(only “direct” damages under the contract)

- Cost to remove the components from satellites. **Maybe.**
- Cost to ship components to Failure, Inc. for investigation. **Maybe.**
- Cost to investigate the failures. **Definitely.**
- Cost to repair or re-design the electric components. **Definitely.**
- Cost to ship repaired components back to Satellites Are Us. **Maybe.**
- Cost expended by Satellites Are Us to re-test the satellites. **Probably Not.**
- Potential damages payable to the commercial satellite customers caused by loss of revenue from delayed launch. **Definitely Not.**
- Payment to Government customers if contracts are terminated by default; damages for delayed launch. **Definitely Not.**

Satellites Are Us Lessons Learned

- (1) Tailor your limitation of liability provision to the types of damages that are likely to occur.
 - (a) leverage permitting, Satellites Are Us should have sought indemnification for all foreseeable costs and damages that could result from failures.
- (2) Define the types of damages: “the parties agree that the costs to ship any defective electronic equipment falls within the category of incidental damages.” Then ensure that “incidental damages” are recoverable.
- (3) Ensure your limitation of liability provision creates certainty. “Contractor’s total liability under this contract...
 - (a) shall not exceed the price set forth in the contract...” or
 - (b) “shall be capped be \$__ per day, for a maximum for __ days.”