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Trimming the Fat in Government Subcontracts -- Recognizing What *Really* Needs to Be Flowed Down by the Prime

Even experienced contractors can find themselves in unfamiliar waters when delving for the first time in the world of government contracts. In many cases, the first step for a commercial company may be acting as a subcontractor (the "Subcontractor") for another company (the "Prime") that is contracting directly with the Government. Even though the Subcontractor's contract is with the Prime and not the Government, certain federal regulations and policies may still apply and place obligations on the Subcontractor. For various reasons, including promoting federal policy and protecting itself contractually, the Government may require that certain clauses included in its contract with the Prime also be included in the subcontract between the Prime and Subcontractor. Similarly, the Prime, for reasons of consistency, to ensure that the Subcontractor's performance will allow the Prime to meet its own contractual requirements, or to protect itself, may include provisions from the prime contract in the subcontract. Such clauses are colloquially known as "flowdown" clauses.

FEDERAL ACQUISITION REGULATIONS

The clauses that are most likely to prompt concern or questions are those clauses that are particular to the realm of government contracts – those set forth in the Federal Acquisition Regulations ("FAR") (as well as certain agency or military supplements to the FAR, *e.g.*, the Defense Federal Acquisition Regulation Supplement ("DFARS") or the Air Force Federal Acquisition Regulation Supplement ("AFFARS")). For FAR clauses, the language of each provision is set forth in FAR Subpart 52.2. In many cases, the contract documents themselves will not contain the clause language, but will only incorporate the language by reference to relevant provisions in FAR Subpart 52.2. In such circumstances, the Subcontractor must review the clause language itself to determine what requirements are being flowed down by the Prime – and whether they in fact are "required" to be flowed down.

If the list of FAR clauses in the subcontract is particularly long, there is a very real possibility that the Prime has attempted to flow down more than is necessary, which could lead to unintended requirements or obligations being placed on the Subcontractor. Therefore, a review of each clause referenced in the subcontract is needed, and the Subcontractor should seek to remove those clauses that are inapplicable or create requirements, obligations or even releases of rights (possibly including rights in the Subcontractor's proprietary data) that are completely

unnecessary.

While the Prime might attempt to incorporate many unnecessary and inapplicable FAR clauses into the subcontract, there are also clauses that the Prime *must* or *should* as a matter of prudence incorporate into the subcontract, either because it is required to do so under its contract with the Government or in order to protect itself from liability where its performance may be dependent on the Subcontractor's performance or compliance. These flowdown clauses come in two varieties: mandatory flowdowns and essential flowdowns (sometimes also referred to as necessary flowdowns).

MANDATORY FLOWDOWNS

Mandatory flowdown clauses are those contract clauses that, by their terms, must be incorporated in the Prime's subcontracts. Typically such clauses in the Prime contract contain language that contractually requires the Prime to include the same clauses, either in substance or with identical language, in all of its subcontracts. For example, FAR 52.214-26, "Audit and Records – Sealed Bidding," includes the following language in paragraph (e):

> The Contractor shall insert a clause containing all the provisions of this clause, including this paragraph (e), in all subcontracts expected to exceed the threshold in FAR 15.403-3(a)(1) for submission of cost or pricing data.

Notably, this flowdown paragraph — by explicitly requiring its own inclusion in subcontracts — places further flowdown obligations on the Subcontractor and could require the Subcontractor to flow down the substance of the same language in its own subcontracts with lower tier subcontractors or suppliers.

Although, in practice, many Primes incorporate FAR clauses into subcontracts by reference without fully setting forth the language of the clauses, not all FAR clauses require the identical language in the Prime's subcontracts. For example, FAR 52.203-7, "Anti-Kickback Procedures," includes the following language in paragraph (c)(5):

> The Contractor agrees to incorporate the substance of this clause, including paragraph (c)(5) but excepting paragraph (c)(1), in all subcontracts under this contract which exceed $100,000.

Because the flowdown of these clauses is mandatory for the Prime, the Subcontractor has no real negotiating power to refuse their inclusion in the subcontract. However, even if these mandatory flowdown clauses appear in the Prime's contract, they are not necessarily applicable to all subcontracts.

As in the two examples above, many FAR clauses with mandatory flowdown language include *threshold values* for the subcontracts that determine whether the clause is applicable. In FAR 52.203-7, above, that threshold amount is $100,000. Some clauses, moreover, do not apply to contracts performed wholly *outside of the United States*. In addition, subcontracts for *commercial items* are subject to fewer flowdown requirements. Commercial items are defined at length in FAR 2.101, but generally include items customarily used by the public for non-governmental purposes, as well as minor modifications, evolutions, combinations and support services provided for such items. FAR Subpart 44.4 significantly limits the mandatory flowdowns for such subcontracts:

> Notwithstanding any other clause in the prime contract, only those clauses identified in the clause at 52.244-6 are required to be in subcontracts for commercial items or commercial components.

FAR 52.244-6, "Subcontracts for Commercial Items," essentially requires the Prime to flow down no more than ten clauses, some of which are only required when certain circumstances apply (*e.g.*, FAR 52.203-15 is only required if the subcontract is funded under the American Recovery and Reinvestment Act of 2009):

> 52.203-13, "Contractor Code of Business Ethics and Conduct"
>
> 52.203-15, "Whistleblower Protections Under the American Recovery and Reinvestment Act of 2009"
>
> 52.219-8, "Utilization of Small Business Concerns"
>
> 52.222-26, "Equal Opportunity"
>
> 52.222-35, "Equal Opportunity for Special Disabled Veterans, Veterans of the Vietnam Era, and Other Eligible Veterans"
>
> 52.222-36, "Affirmative Action for Works with Disabilities"
>
> 52.222-39, "Notification of Employee Rights Concerning Payment of Union Dues or Fees"
>
> 52.222-50, "Combating Trafficking in Persons"
>
> 52.247-64, "Preference for Privately Owned U.S.-Flag Commercial Vessels"

In addition to the nine clauses above, FAR 52.244-6 also requires its own terms be flowed down in subcontracts awarded under the Prime's contract.

FAR 52.244-6 further states that, though not required, the Prime "may flow down to subcontracts for commercial items a minimal number of additional clauses necessary to satisfy its contractual obligations." Such clauses, therefore would not be mandatory, but essential or necessary for the Prime's performance.

ESSENTIAL/NECESSARY FLOWDOWNS

Essential or necessary flowdown clauses are those that a Prime must flow down to protect itself or otherwise "satisfy its contractual obligations" to the Government. Examples of such clauses might be a Changes clause or a Termination for Convenience clause. If changes to the scope of work or the Government's requirements are anticipated, the Prime must flow down some form of Changes clause in its subcontracts so that it can then change the scope of work and its own requirements for its subcontracts. The consequence of failing to do so, of course, is a subcontract that does not include a "duty to proceed obligation" where there is a dispute with the subcontractor as to whether a particular Prime or Government direction is a change. If the Subcontractor is convinced it is a change, it can decline the "change" and either continue to perform the contract as originally written or, if the Prime persists, stop work on the grounds of breach of contract. The basic point is that the absence of a Changes clause shifts the negotiating leverage to the Subcontractor.

A Termination for Convenience clause allows the Government to terminate the prime contract for any reason, with some provision for reimbursement of the Prime's incurred costs. Under the *Christian* doctrine, as set forth in *G.L. Christian & Assocs. v. United* States, 312 F.2d 418 (Ct. Cl. 1963), a "Termination for Convenience" clause is read into all Government prime contracts, even when not set forth therein, since it is otherwise required by regulation. However, the *Christian* doctrine does not appear ever to have been applied to subcontracts. If the Government terminates the prime contract for convenience, the Prime could potentially be liable for normal contract damages (including lost profits) unless the subcontract flowed down the Termination for Convenience clause or incorporated some form of termination clause or other limitation of liability that would operate under such circumstances.

While such essential or necessary flowdown clauses are not mandatory, the Prime will likely insist on their inclusion in the subcontract. However, because the exact language of a particular FAR clause is not required for these "non-mandatory" flowdowns, there is room for negotiation. The Subcontractor's ability to favorably negotiate such clauses will likely depend on the relative negotiating power of the parties and the timing of the negotiations. This can often be seen in connection with the Price Reduction for Defective Cost or Pricing Data clause, FAR 52.215-10. This is not a mandatory flowdown clause, but no Prime wants to be liable for defective pricing that is traceable to the Subcontractor's data. The variability that is seen in the flowdowns used to protect the Prime here largely relate to the scope of the indemnity – is it all inclusive so as to make the Prime whole not only for the actual defective pricing at the subcontract level but also for the "upstream" impact caused by the Prime's overhead and G&A loadings? Or is it limited to the measurement of the defective pricing by the Subcontractor? In the case of a Termination for Convenience clause, the Subcontractor may be able to negotiate the contract clause such that, rather than give the Prime the same broad freedom as the Government

to terminate the contract for any reason, the Prime only has the ability to terminate the contract for convenience when and to the extent that the Government has already terminated the prime contract for convenience.

CONCLUSION

Ultimately, the Subcontractor has the freedom to accept or refuse the Prime's attempts to flow down requirements or provisions from its prime contract by simply walking away from the negotiations. However, in order to get the deal done, the Subcontractor may have to compromise and accept such clauses, including FAR provisions or regulatory requirements with which traditionally commercial companies may not be familiar. By analyzing the clauses at issue, and determining which clauses are mandatory, essential, or possibly completely unnecessary or inapplicable, the Subcontractor can best determine its options. Many times, due to inattention, ignorance, or simply to save time, the Prime might attempt to flow down each and every FAR clause from its prime contract. In such cases, the Subcontractor might be able to significantly truncate the list of such clauses simply by asking the Prime to take a closer look at its own requirements.

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