

2007 Annual Update
on Government Contracts

U.S. GOVERNMENT SUBCONTRACTS SPECIAL CONSIDERATIONS FOR PRIMES AND SUBS

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Government Contracts Seminar 2007



What makes a government contract different from any other contract?

- Government Subcontracts – special considerations for Primes and Subs
 - From the perspective of both the Prime and the Sub
- FAR and the Law – “What are all these clauses and what do they mean?”
 - Background on the FAR, Commercial Items and Common Mistakes

Government Subcontracts – Negotiation Strategy Considerations for Primes and Subs



- What is a subcontract?
- View of a prime/higher tier subcontractor
- View of a lower tier contractor
- Most common provisions
- Battle of the Forms
- Examples of bad subcontract provisions
- Terms and Conditions Checklist

What is a subcontract?



- FAR defines a subcontract as 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 modification to purchase orders. FAR 44.101
 - definition focuses on status of a subcontractor



- While, by definition, a subcontract involves a “contract” in support of a higher tier contractor, many of the issues involving subcontract formation, negotiation, performance and remedies are equally applicable to other forms of agreements, such as cooperative agreements, grants, joint ventures, teaming arrangements and “other transactions”

Subcontracts Are a Hybrid of a Government Contract and a Commercial Contract



- Government contract statutes, rules, regulations, and clauses apply to the extent they are incorporated into the agreement
- “Christian” doctrine G. L. Christian & Associates v. U.S., 312 F.2d 418 (Ct. Cl., 1963) does not apply to subcontracts
- Subcontracts are also governed by commercial law such as the Uniform Commercial Code, other statutory laws or the common law

From the Prime/Higher Tier Contractors' Perspective



- Prime Contractor usually has the most bargaining power
- There are some clauses in its contract with the government that must be flowed down, or the Prime will be in breach
- For example, even for government subcontracts for commercial items, the prime must flow-down at a minimum, the clauses on Equal Opportunity; Affirmative Action for Disabled and Vietnam Era Veterans; and Affirmative Action for Workers with Disabilities



But, not all provisions have to be
or even can be flowed-down

- Since the subcontract is likely to be only for a subset of the Prime's requirements, some provisions are likely to be not applicable



- For example, a prime contract for a government unique product may require subcontracts for commercial items. Those subcontracts should follow the commercial item requirements, substantially reducing required flow-downs (FAR 52.244-6)
- Also, note that some clauses are required to be flowed down only at certain tiers, or only if the subcontract exceeds a certain threshold



- There are other clauses which, while not mandatory, should be modified and flowed-down in order to Protect the Prime's interests.

- Examples include:
 - Termination Clauses
 - Changes
 - Indemnification
 - Warranty



- Finally, there are other clauses which really cannot be flowed down in their original form, even though the content of the clause may need to be addressed

- Example
 - Disputes
 - Applicable law
 - Forum of choice
 - ADR

From The Subcontractor's Perspective



- Often the subcontractor feels powerless to challenge the terms offered by the Prime
 - Real or illusory?
- Subcontractor needs to recognize the clauses which are mandatory for the Prime to flow down
 - Don't waste time trying to negotiate these



- Subcontractor needs to accept the clauses the Prime must include to cover its legitimate risk (termination, changes, etc.)
- Subcontractor needs to be able to identify the clauses that are not mandatory flow-downs, that do not cover a Prime's legitimate risk, or that cause a burden on the subcontractor
- Challenge for the Subcontractor is then to convince the Prime these superfluous clauses add unnecessary cost, are unnecessarily burdensome to the subcontractor, or are just unfair



- Subcontractor needs to consider whether once accepted, it will be able to flow-down clauses to its own subcontractors
- Finally, since the negotiation typically starts from the Prime's document, the Subcontractor has to consider if all of its concerns are met, e.g., payment terms, intellectual property, etc.

Summary of Terms To Analyze for Consistency Between Prime and Sub



- Changes
- Termination
- Indemnification
- Warranty
- Setoff
- Tooling
- Service/Replacement parts
- Duration (commercial)
- Quantity (commercial)

Comparison With Commercial Contracts



- Analysis is similar under UCC, generally
- Outcome is determined by leverage
 - Unique product?
 - Low cost provider?
 - Captive Technology?

Changes Clause



- The government has the right to issue change orders within the general scope of the prime contract
- The Prime contractor can then request an equitable adjustment (“REA”) in terms of cost or schedule extension (or both) due to the change

The Prime Must Make Sure



- It can pass government directions to the subcontractor without the change being considered a breach and without the subcontractor rejecting the change
- The subcontractor's REA for cost or schedule adjustment is submitted in a timely manner so the Prime can meet its own obligations under the prime contract

However, It Is Legitimate For The Subcontractor To:



- Draw a distinction between a government-directed change and a prime contractor-directed change with respect to
 - unilateral vs. bilateral nature
 - cost and schedule adjustments
 - utilization of the Disputes clause
 - the nature of the change the subcontractor is willing to consider

Changes Clauses In Commercial Contracts



- Changes clauses vary depending on leverage and, sometimes, attention to detail
- Generally set forth scope of permissible changes, and process for payment
 - Buyer discretion for adjustments for changes?
 - Equitable price adjustments for all changes?
 - Price adjustment for only “cost-impact” changes?

Changes Clauses In Commercial Contracts (Cont'd.)



- If not addressed in contract, then every change may open the door for negotiation of all terms

Termination Clauses



- The Prime needs to be able to flow this clause down so that if its contract is terminated for the government's convenience, it can likewise terminate the subcontractor's contract
- The Prime needs to be able to fairly resolve subcontractor termination settlement proposals in a timely way that will allow the prime to be fully reimbursed from the government



- The subcontractor may want to distinguish between a government-directed termination for convenience and a contractor-directed termination for convenience
- The subcontractor wants to have the same rights and recoveries as the prime contractor if the government terminates for convenience
 - The contractor directed termination can arise from the inclusion of the FAR termination clause with a general “change the government to contractor” incorporation

Termination for Convenience In Commercial Contracts



- One of most hotly contested provisions in most commercial contracts
- Outcome depends on leverage
 - Long-term Agreement vs. Order-by-Order
 - Recovery of Capital, Tooling, Investment Costs
 - Be wary of disclaimers
 - Permissible obsolescence claims typically are limited

Terminations for Default



- The Prime needs to clearly identify the events which will support a default of the subcontractor to protect its interests and minimize the risk of having its own contract default terminated
- The subcontractor needs to be assured it would only be default-terminated for a material breach, and that if there was a disagreement concerning the default action, that the subcontract offers a viable dispute resolution process.

Termination for Default In Commercial Context



- Same negotiation dynamic as government contracts
 - Buyer wants unbridled discretion
 - Seller wants as many limitations as possible
- However, also consider:
 - Insolvency as justification for termination
 - Cost-competitiveness as justification for termination

Disputes Clause



- Unaltered FAR Disputes clause cannot be flowed down because the Prime cannot give the various BCAs or Court of Federal Claims jurisdiction to decide a disputed claim

A Subcontract Disputes Clause Needs To Meet The Needs of The Prime By:



- Making sure the subcontractor is “bound” by contracting officer final decisions based upon the prime contract and those decisions that were appealed
- Making sure the subcontractor must continue to perform despite the dispute
- Recognizing some disputes will be solely between the Prime and subcontractor and are therefore not going to be decided by the contracting officer

A Subcontract Disputes Clause Needs to Meet The Needs of The Subcontractor By:

- Recognizing some disputes cannot be settled under the prime contract's Disputes clause
- Providing an efficient, effective and fair disputes process
- Making sure that if the subcontractor is going to be bound by contracting officer decisions under the prime contract, it has adequate information, input and appeal rights

Disputes Clauses In Commercial Contracts



- Arbitration?
- Mediation?
- Required good-faith negotiations?
- Litigation?

Warranty Clauses in Government Contracts



- The contract can have express warranty requirements.
- FAR 52.212-4(o) includes a warranty of merchantability and a warranty of fitness for a particular purpose.
 - These are warranties found in the UCC which applies to goods.
 - The FAR’s definition of commercial items covers both goods and services.

Otherwise, like commercial warranty provisions

Warranty Clauses in Commercial Contracts



- What is scope of warranty?
 - Strict compliance with specifications, samples, drawings, designs or other requirements (including performance specifications)?
 - Goods merchantable and of good material and workmanship and free from all defects?
 - Goods selected, designed, manufactured and assembled by Seller based on Buyer's intended use?
 - Strict compliance with applicable industry standards, quality control and inspection standards, and all statutes, rules and regulations, of any kind or nature?
 - Free from all liens and encumbrances?
 - Free from all patent, trademark, copyright, trade secret or other intellectual property right infringement or claims?

Warranty Clauses (Cont'd.)



- Length of Warranty Period?
 - Can be modified by contract. For example, can extend until:
 - Expiration of all warranties made by Buyer to its customer concerning Buyer's product incorporating the Goods; or
 - Expiration of the longest time period which Buyer's customer may be required, by contract of law, to repair or replace the Goods or Buyer's product incorporating the Goods, if the Goods are defective or nonconforming to any warranties.
 - Warranty from subcontractor should parallel warranty to customer

Indemnification



- Most common bases for indemnification:
 - Breach of warranty/recall
 - Intellectual property
 - Third-party claims, personal injury, etc.
- Attorneys' fees/costs of litigation
- Costs of settlement/control of settlement
- Government contracts have patent indemnification provisions, otherwise use the changes/claims process

Battle of the Forms



- What happens when both contractors have standard terms and conditions, exchange them, and never work out the differences?

What If:



1. The two forms address a crucial term in a different way?
2. A crucial term is addressed in the first form, but not the second?
3. A crucial term is addressed in the second form, but not the first?
4. At least one form states there will be no contract unless the other party agrees to all its terms and offers no others?



5. Prior to the exchange of forms, there was an oral agreement?
6. No forms are used, but a variety of messages and letters and occasional oral discussions produce an agreement?
7. The second form differs so radically from the first it does not constitute an “acceptance”?

Application to Commercial/Manufacturing Contracts



- Particularly problematic in world where contract documents commonly include:
 - Request for Quotation
 - Quotation
 - Letter of Intent
 - Purchase Order
- Each document may have own set of standard terms and conditions

UCC 2-207 – Additional or Different Terms in Acceptance



- A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.
- The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:



- the offer expressly limits acceptance to the terms of the offer;
 - they materially alter it; or
 - notification of objection to them has already been given or is given within a reasonable time after notice of them is received.
- Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this act.

UCC 2-207; Mich. Comp. L. 440.2207

Battle of Forms – Lessons Learned



- Always limit acceptance to terms of the offer
 - If possible, include on purchase order (or other document) specific language stating that:
 - This Order is effective and expressly conditional on Seller's assent to all terms and conditions in this Order that are additional to or different from those stated in Seller's quotation or other offering documents.
 - Seller's assent to this provision will be manifested by delivery or any portion of the goods designated herein.
- Always better to be the offeror
 - Control own destiny
 - Your terms are included, unless objected to

Bad Examples of “Standard” Terms and Conditions



■ Price Warranty

- Seller warrants that the prices for the articles sold Buyer hereunder are not less favorable than those currently extended to any other Customer for the same or similar articles in similar quantities. In the event Seller reduces its price for such articles during the term of the Order, Seller agrees to reduce the price hereof correspondingly.

Bad Examples of “Standard” Terms and Conditions (Cont’d)



■ Changes

- Buyer reserves the right to direct changes in the delivery schedule and/or schedule of the work to be performed at any time to comply with the requirements of the Prime or its Subcontract under which this Order was issued, and such shall be implemented by Seller without any cost to Buyer or increase in Purchase Order Price. (Or, “Buyer has discretion to grant price increase”)

Bad Examples of “Standard” Terms and Conditions (Cont’d)



■ Pricing

- Seller understands and agrees that in addition to any other rights that the Buyer has under this Purchase Order, the Buyer reserves the right to reduce the Purchase Order Price at any time prior to three years after final payment to Seller under this Purchase Order, in the event that the Buyer determines that the prices in this Purchase Order exceed the intrinsic value of the supplies purchased.

Bad Examples of “Standard” Terms and Conditions (Cont’d)



■ Setoff

- All amounts due Seller, or any of its subsidiaries or affiliates shall be considered net of indebtedness or obligations of Seller, or any of its subsidiaries or affiliates to Buyer or any of its subsidiaries or affiliates.
- Buyer or any of its subsidiaries or affiliates may setoff against or recoup from any amounts due or to become due from Seller, or any of its subsidiaries or affiliates to Buyer or any of its subsidiaries or affiliates however and whenever arising. If Buyer or any of its subsidiaries or affiliates reasonably feels itself at risk, Buyer or any of its subsidiaries or affiliates may withhold and recoup a corresponding amount due Seller or any of its subsidiaries or affiliates to protect against such risk.

Bad Examples of “Standard” Terms and Conditions (Cont’d)



■ Setoff (cont.)

- If an obligation of Seller or any of its subsidiaries or affiliates to Buyer or any of its subsidiaries or affiliates is disputed, contingent or unliquidated, Buyer or any of its subsidiaries or affiliates may defer payment of all or any portion of the amount due until such obligation is resolved.

Bad Examples of “Standard” Terms and Conditions (Cont’d)



■ Safety Parts

- From time to time Buyer reserves the right to add or delete “Critical Characteristics or Processes” at no additional cost or liability.

Bad Examples of “Standard” Terms and Conditions (Cont’d)



■ Jurisdiction

- All litigation concerning the supplies and services stipulated in this Purchase Order resulting from the inability to reach an informal agreement shall be judged exclusively by the Tribunal of Paris. French law shall apply in all cases.

■ Invoices

- Seller’s failure to submit an invoice within 180 calendar days after delivery shall constitute a waiver of any Buyer liability to make payment.

Bad Examples of “Standard” Terms and Conditions (Cont’d)



■ Buyer’s Property and Information

- Any designs, drawings, dies, molds, tooling, technical data/information, materials, equipment, etc. that Seller makes or buys from others for producing the supplies/services and charges to Buyer’s accounts, shall become the Buyer’s property immediately upon manufacture or procurement.

■ Quality Assurance Records and Retention Requirements

- Supplier shall maintain Quality Assurance related records and retain them for a period of not less than seven (7) years.

Bad Examples of “Standard” Terms and Conditions (Cont’d)



■ Changes

- Purchaser at any time shall have the right to make changes in this Order, but no additional charge will be allowed unless authorized by Purchaser’s written amendment to this Order.

Terms and Conditions Review



- When is the last time you reviewed your standard terms and conditions?
 - You have a problem if your purchase order still references ASPR clauses.
- Have you looked at the terms and conditions sent to you by the other party?
 - Is this the function of a properly trained specialist in your company?

Terms and Conditions Review



- Have you considered whose form takes precedence?
 - How do you know if you have a deal?
- Do you have an adequate dispute resolution process in your purchase order?
 - Have you considered ADR?
 - Have you stated where, or how and by whom a dispute will be resolved?