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Flowing Down Clauses To Non-U.S. Subcontractors: An Approach For Ensuring A Meeting Of The Minds

Even the most experienced U.S. Government prime contractors can suffer consternation when considering which Federal Acquisition Regulation clauses to flow down to non-U.S. subcontractors. Some prime contractors capitalize on the strength of their negotiating position by flowing down all the clauses in their prime contracts, but this sets up a potential dispute if the subcontractor accepts the clauses without understanding them. Other prime contractors flow down few or no contract clauses, instead opting for a purely commercial contract for the sake of negotiating ease, but this approach may put the prime contractor in technical default of its contractual obligations to the Government. Certainly, neither approach constitutes a “best practice.”

The issue of flow-down clauses has become quite important in this age of globalization. According to Defense News, 59 of the top 100 prime contractors to the U.S. Department of Defense are foreign-based companies. See DOD Top 100 Ranking 2007, Defense News, at www.defensenews.com/static/features/top100/charts/rank_2007.php. This includes prime contractors from Australia, Canada, Finland, France, Germany, India, Israel, Italy, Japan, the Netherlands, Norway, Russia, Singapore, South Korea, Spain, Switzerland, Turkey and the UK. Thus, three-fifths of the top DOD contractors are non-U.S. companies. One could surmise that the percentage of non-U.S. prime contractors to civilian agencies is even higher. Additionally, although there are no statistics kept on the number or size of non-U.S. subcontractors under U.S. Government prime contractors, it is probably safe to assume that the number is significant and growing.

So how should sophisticated U.S. Government contractors approach flowing down FAR and agency-

level clauses to non-U.S. subcontractors, many of whom have little or no understanding of the U.S. procurement system? This article addresses this topic by (1) providing an overview of the concept of flow-down clauses and how they typically apply, (2) addressing the special flow-down rules for commercial-item contracts and (3) exploring how the rules change if the subcontract is to be performed outside the U.S. The article is not intended to be a final resolution to this issue, but rather a jumping-off point for creating thinking in this area.

The Concept of Flowing Down Contract Clauses—The FAR contains hundreds of contract clauses implementing federal statutes and regulations. Those laws and regulations, as well as the clauses themselves, require a prime contractor to incorporate—or “flow down”—certain clauses into subcontracts related to the prime contracts. The primary factors in determining whether a clause must be included in a particular agreement are (a) whether the agreement is a “subcontract” and (b) whether the flow-down is mandatory.

What is a Subcontract?: As a threshold matter, flow-down requirements apply only to “subcontracts.” This of course begs the question: What is a subcontract versus a supplier or vendor agreement? This topic has been addressed in detail in the excellent article, “Identifying ‘Subcontractors’ Under TINA and Access-To-Records Statutes: Filling an Annoying Gap in Government Contracts Jurisprudence,” by Richard C. Johnson, 31 Pub. Cont. L.J. 739 (2003).

Regrettably, FAR 2.101 does not contain generic definitions of the terms “subcontract” and “subcontractor.” FAR pt. 44, which contains subcontracting policies and procedures, includes the following definitions:

“Subcontract” means any contract as defined in Subpart 2.1 entered into by a subcontractor to furnish supplies or services for performance of a prime contract or a subcontract. It includes but is not limited to purchase orders, and changes and modifications to purchase orders.

“Subcontractor” means any supplier, distributor, vendor, or firm that furnishes supplies or services to or for a prime contractor or another subcontractor.

If only it were that simple! As Richard Johnson observed, the terms “subcontract” and “subcontractor” are “so frequently used in the FAR as to lurk on nearly every page, so frequently indeed as to defy precise enumeration.” *Id.* at 740. The often-inconsistent definitions of these terms, also found in agency supplemental regulations, result in an agreement constituting a subcontract for some purposes but not for others.

That being said, there are several “rule-of-thumb” approaches that prime contractors use in considering whether an agreement is a subcontract. One approach is to rely on the most conservative definition of the term “subcontract” from the clauses actually found in the relevant prime contract. Another approach is to consider whether the prime contract specifically calls for the particular goods or services being purchased from the vendor, or whether the agreement’s scope of work is tailored to the specific prime contract. Another is to determine the source of funds—whether federal funds or from other sources. Yet another is to determine whether the cost of the vendor agreement should be charged as a direct cost to a contract, versus an indirect charge. The closer the prime contract and the supplier agreement are affiliated, the more likely the agreement should be considered a subcontract, as a general matter.

Is the Flow-Down Mandatory, Advisable or Entirely Optional?: Not all FAR and agency-level clauses are mandatory flow-downs. The FAR contains only about 70 mandatory clauses that apply to noncommercial-item prime contracts. Determining which clauses are mandatory is not always easy, however. In most cases, the clause or FAR provision mandating the clause instructs when the clause must be flowed down entirely or in substance. In other cases, the FAR can require extensive interpretation of other clauses or the underlying statute. See, e.g., FAR 52.222-41, “Service Contract Act of 1965” (requiring the flow-down of the clause to “all subcontracts subject to the Act”). In yet other cases, the FAR clause requires application of the clause to the specific circumstances. See, e.g., FAR 52.219-9, “Small business subcontracting plan” (requiring the contractor to insert FAR clause 52.219-8, “Utilization of small business concerns,” into “all subcontracts that offer further subcontracting opportunities”).

For these FAR clauses that are not mandatory flow-downs, the prime contractor nevertheless may wish to flow them down to protect its interests. One example is the termination for convenience clauses described in FAR 49.502 and set forth in FAR 52.249. These clauses permit the Government to terminate a prime contract for almost

any reason. A prime contractor will seek a corresponding right with its subcontractor to avoid conflict with the Government over the allowability of the subcontract costs if it finds itself with a terminated Government contract. Even if ultimately unsuccessful, the effort of seeking the convenience termination protection may provide support for recovery of costs in a termination settlement if the subcontractor demands full payment.

Thus, best practices would have the prime contractor determine which clauses are mandatory flow-downs and which are advisable, on an agreement-by-agreement basis. In reality, this can be a time-consuming process undertaken by few prime contractors, who instead rely on standard forms essentially flowing down every possible clause. The issue becomes even more challenging in the context of a non-U.S. subcontractor. If the subcontractor is unwilling to accept the flow-down clauses—or worse, if it accepts the clauses without understanding them and, thereby, puts the prime contractor in a default position—the prime contractor must make difficult choices.

One option is to try to limit the flow-downs for all non-U.S. subcontractors, and instead to incorporate many of the principles found in the FAR clauses into commercial language in the text of the subcontract. The following section shows how this limiting can be done effectively in certain circumstances.

Limiting Flow-Down Clauses for Non-U.S. Subcontractors—One way to limit flow-downs clauses is for the prime contractor to make a proper determination that the agreement is a “commercial-item” subcontract. Another way is to look at the extraterritorial application of the flow-down clauses. Both methods are described below.

Commercial-Item Subcontracting: If a prime contractor wishes to flow down as few contract clauses as possible, it may first try to rely on the rules applicable to commercial-item subcontracts.

The Federal Acquisition Streamlining Act of 1994 and its implementing regulations require most Federal agencies to purchase commercial items to the maximum extent practicable. See FAR 12.101. The definition of “commercial item” is contained in FAR 2.101. If the agency determines that the goods or services meet that definition, special regulations apply to the acquisition—including waiver of many procurement statutes and regulations; the result is a sharp reduction in the number of mandatory FAR clauses. FAR 12.301 states that commercial-item contracts shall include only those clauses required to implement the streamlined list of statutes applicable to them.

A commercial-item prime contractor must include in its subcontracts FAR 52.212-4, “Commercial terms and conditions—commercial items,” and FAR 52.212-5, “Contract terms and conditions required to implement statutes or executive orders—commercial items.” The former clause addresses several contractual issues such as invoicing, termination and changes in textual form. The latter clause serves as a streamlined “catch-all” of legal mandates applicable to commercial-item contracts. FAR 52.212-5(e) states that the prime contractor is required to flow down only 10 specific clauses to the extent “required by the clause.” Those mandatory flow-downs are:

- FAR 52.219-8, “Utilization of small business concerns”;
- FAR 52.222-26, “Equal opportunity”;
- FAR 52.222-35, “Equal opportunity for disabled veterans and veterans of the Vietnam era”;
- FAR 52.222-36, “Affirmative action for workers with disabilities”;
- FAR 52.222-39, “Notification of employee rights concerning payment of union dues and fees”;
- FAR 52.222-41, “Service Contract Act of 1965”;
- FAR 52.222-50, “Combating trafficking in persons”;
- FAR 52.222-51, “Exemption from application of the Service Contract Act to contracts for maintenance, calibration, or repair of certain equipments—requirements”;
- FAR 52.222-53, “Exemption from application of the Service Contract Act to contracts for certain services—requirements”; and
- FAR 52.247-64, “Preference for privately owned U.S.-flag commercial vessels.”

The commercial-item prime contractor may include in its subcontracts a minimal number of additional clauses necessary to satisfy its contractual obligations, but it is not required to do so. *Id.* at 52.212-5(e)(2). Thus, if a prime contract is entered into as a commercial-item contract, the number of clauses flowed down to subcontracts may be minimal.

Furthermore, regardless of whether a prime contract is written as a commercial-item contract, the prime contractor may write its subcontracts as commercial-item subcontracts if the goods or items being procured meet the definition of “commercial item” in FAR 2.101. This policy is found in FAR 52.244-6, “Subcontracts for commercial items,” which is mandatory in all prime contracts. That clause requires the prime contractor, to the maximum extent practicable, to incorporate, and require its subcon-

tractors at all levels to incorporate, commercial items as components to be supplied under the prime contract. *Id.* at 52.244-6(b). This mandate maximizes the use of commercial-item subcontracting at all levels, regardless of whether the prime contract is a commercial-item contract. See *id.* at 52.244-6(d).

FAR 52.244-6(c) has the benefit of streamlining the flow-downs even further. It requires the prime contractor to flow down only six clauses: FAR 52.219-8, 52.222-26, 52.222-35, 52.222-36, 52.222-39 and 52.247-64. Thus, even if the prime contract is not a commercial-item contract, the prime contractor and its subcontractors must, to the maximum extent practicable, purchase goods and services as commercial items, which, of course, also limits the number of flow-down clauses.

Applicability of Flow-Downs in Subcontracts Performed Outside the U.S.: In prime contracts and subcontracts for which the commercial-item exception is not available, flow-downs may be limited by analysis of the extraterritorial application of the clauses. Many mandatory FAR flow-down clauses have no extraterritorial effect. That is, by their own terms, they do not apply if the contract is performed outside the U.S. Understanding this issue further allows prime contractors to reduce the number of flow-downs to its non-U.S. subcontractors.

Most of the socioeconomic clauses required for commercial-item contracts and subcontracts do not apply extraterritorially.

- FAR 52.222-26, 52.222-35, 52.222-36 and 52.222-39 (equal opportunity and affirmative action clauses), by their own terms, do not apply to contracts for which all work will be performed outside the U.S. and its territories by employees who were not recruited in the U.S. or its territories. See *id.* at 52.222-26(b), 52.222-35(d), 52.222-36(d) and 52.222-39(e).
- FAR 52.222-41, 52.222-51 and 52.222-53 apply only to subcontracts subject to the SCA. See, e.g., FAR 52.222-41(l). That Act applies only to contracts for which the principal purpose is to furnish services in the U.S. through the use of service employees, 41 USCA § 341. Accordingly, these clauses do not apply to contracts performed outside the U.S. and its territories.
- FAR 52.219-8, “Utilization of small business concerns,” on the other hand, contains no territoriality limitation. As a result, it technically must be flowed down to contacts outside the U.S. even if the text of the clause would have little practical effect outside the U.S.

- FAR 52.247-64, "Preference for privately owned U.S.-flag commercial vessels," applies whenever items are to be delivered to the Government and are being shipped by commercial ocean vessels. Thus, it applies outside the U.S.
- Curiously, FAR 52.222-50, "Combating trafficking in persons," is required to be included in all prime contracts (see FAR 52.22.1705(a)), but FAR 52.244-6 does not list it as a mandatory flow-down clause for commercial-item subcontracts. In this author's view, this circumstance probably is an oversight that will be corrected.

Thus, for commercial-item subcontracts, there are only three mandatory flow-down clauses. For noncommercial-item subcontracts, the prime contractor can perform a clause-by-clause analysis to determine which clause are mandatory flow-downs for noncommercial-item subcontracts, given the language of the clause and any extraterritorial limits on their applicability.

Three Not-So-Simple Steps—Given this analysis, a prime contractor wishing to avoid complicating negotiations with foreign suppliers by seeking unnecessary flow-down clauses in its agreements should take three steps:

- first, determine whether the agreement should not be considered a subcontract, but rather should be

deemed a vendor or supplier agreement to which flow-downs do not apply;

- second, if the agreement must be a subcontract, determine whether it can properly be awarded as a commercial-item subcontract; and
- third, attempt to limit the flow-down clauses by identifying those that have extraterritorial relevance and eliminating those that do not.

By following this approach, the prime contractor can thoughtfully determine which FAR clauses it must flow down and then make decisions about which clauses it wishes to flow down. For example, the prime contractor may wish to flow down, in substance if not in form, the important features of FAR clauses on terminations, changes, intellectual property and insurance requirements. These decisions should be made with a full recognition of the prime contract obligations and the need to educate the non-U.S. subcontractor on any clauses incorporated by reference, to ensure a meeting of the minds.



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