

APTAC Body of Knowledge Competency Guide

C. Basics of Contracting with Government Entities

C.14.2 Flow-Down Clauses

Description

When contracts contain one or more requirements that certain clauses must be imposed on subcontractors, those clauses are referred to as "flow-down clauses" because they "flow" downstream through the specified levels of contracting relationships.

When the contractor fails to understand how to flow down prime contract requirements to the subcontractors, confusion results in many areas of subcontract administration. Some companies simply incorporate their entire prime contract into the subcontract, usually with a preamble to the effect of "wherever in these clauses the term 'government' appears, it shall be construed to mean 'contractor' and the term 'contractor' shall be construed to mean 'subcontractor'". This technique, sometimes referred to as the "preamble method", can deprive both parties of rights and obligations, and can damage the privity principle¹. The client should be advised to never agree to such a subcontract, nor to issue one to its own subcontractors. Here are some examples of clauses that could cause problems if flowed down to subcontractors:

The "Disputes" clause applies only to the relationship between the government and its prime contractor, and the government cannot have a role in resolving disputes between the contractor and subcontractor. The clause invokes the Board of Contract Appeals which has no authority over subcontracts. When transferring roles through the preamble described above, the subcontractor's right to appeal ends with the contractor, which means capitulating to the party that has allegedly wronged the subcontractor. After the subcontractor agrees to such a clause, its rights to litigation against the contractor may be limited.

The government contract calls for a period of time in which something must occur, and if the same period of time is transferred to the subcontract, especially if it is flowed down multiple tiers, the subcontractors will have used up the entire time and the contractor cannot comply with the time limit in its contract with the customer. Thus, the opportunity to file a legitimate claim, such as payment for changed work, may be lost.

Rights In Data is an important clause which can give the subcontractor's competitor access to trade secrets and other intellectual property assets if flowed down improperly. Another flow-down trap is the government's termination clauses; in some states, legal opinion may be needed before translating these to the UCC-governed subcontract relationship. Insurance coverage is another example where prudent business judgment should be exercised. There are many other examples, too numerous to discuss in detail here. Counselors should become knowledgeable about the effect on subcontracts when prime contract clauses are flowed down.

¹ See discussion of "privity" in the BOK section on "Subcontracting Principles"

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Contractors that use the preamble method signal they may not be competent in subcontract management, and the subcontractor can expect continued difficulties in the relationship. The client should insist on having all flow-down clauses tailored with appropriate language, with addition of an alternative disputes resolution clause with a neutral arbitrator or mediator. Some contractors refuse to negotiate and bully the small subcontractor into accepting the entire prime contract incorporated into the subcontract. The client should submit requests for clarification of how the prime contractor proposes to administer the clauses that don't make sense, and insist on getting answers before signing the subcontract.

Remember: The FAR does not apply to businesses. It applies only to the government. It is only through contract clauses, which the contractor agrees to, that portions of the FAR can be imposed on the contractor, and thereby flowed down to the subcontractors. Aside from prime contract clauses that specify flow-down requirements, the government has no jurisdiction over subcontract clauses.

It is helpful to read the FAR and learn why government personnel do what they do. It is far more important for contractor and subcontractor personnel to read their contracts carefully, including the text of FAR clauses that are “incorporated by reference” (IBR), in which only the FAR source and not the entire text is cited in the contract document. This is a practice unique to federal contracts and rarely if ever seen in the private sector, because there is no similar “library” of regulated contract clauses to select from except in the FAR System. Contractors and subcontractors must download the text of all IBR clauses and study them before incorporating them into a subcontract agreement.

In compiling their flow-down document, contractors should select all mandatory flow-down clauses, plus any of the others that relate to the contractor’s reliance on the subcontractor for satisfactory performance of the customer’s requirement, and adjust the wording appropriately. Contractors and subcontractors should be aware of how selection of flow-down clauses affects factors such as risk, time, and price.

A federal contract involving subcontracts for commercial items only requires a small number of FAR clauses to be flowed down, but the parties to the subcontract should carefully consider which additional prime contract clauses they choose to add.

Some of these clauses must be imposed on subcontractors "in their entirety", some call for the substance of the clause to be incorporated into subcontracts, and some do not specify a flow-down requirement but the prime contractor should protect its rights by flowing down certain requirements anyway, such as those with time limits for action.

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References

FAR 52.244-6

Reference materials posted at <http://www.onvia.com/business-resources/articles/subcontracting?page=1>

See also <http://www.wifcon.com/discussion/index.php?/topic/2227-mandatory-flowdowns-to-subcontractors/>