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DIFFERENCES BETWEEN

managing a

SUBCONTRACT

and a

GOVERNMENT

PRIME

CONTRACT

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MOST CONTRACTS HAVE MANY SIMILAR ASPECTS.

For example, certain boilerplate conditions, the process of negotiation, and the interpretation of key terms and conditions are often similar from one contract to the next—especially when considering terms of art specific to the subject of the contract. When you compare a U.S. federal government prime contract to the many subcontracts that may be awarded in support of its performance, however, significant differences begin to appear, even though the prime contract and the subcontracts are all contributing to the same result.

Depending on the industry, often 60 to 80 percent of the prime dollars ultimately flow to subcontractors and suppliers. Given the importance of the subcontracting team to the successful performance of the prime contract, the prime contractor and the government should be intensely interested in the proper management of the subcontracts. Since the government has no direct relationship with the subcontractors, the government must rely on the prime to properly select and manage the team of subcontractors while properly drafting contracts that will protect both the government customer and the prime contractor—and at the same time being fair and reasonable with each of the subcontractors. In legal terms, this simply says that the government and the subcontractors are not “in privity of contract” with each other. The prime contractor has full responsibility for dealing with the government customer

as a seller and dealing directly with each of the first-tier subcontractors as a buyer. This role of being the intermediary and the added twist of preserving the government flow down requirements makes the differences in managing the two contracts significantly more substantial.

This article will highlight five specific aspects of managing subcontracts that distinguishes them from the management of a government prime contract. While there are others, paying specific attention to these five will improve both your understanding of the contracting relationship and your successful management of the subcontracting team, as appropriate. This in turn will reduce performance risk and improve the bottom line for the prime.



#1

Governing Law

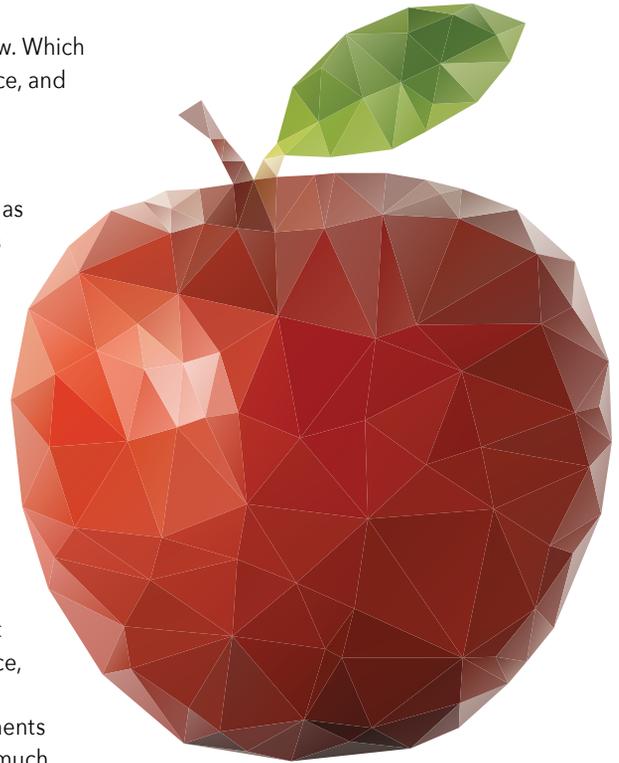
The first of these differences is the issue of governing law. Which body of law will be applied to the formation, performance, and discharge of the contract?

Federal Common Law

Federal prime contracts are governed by what is known as the “federal common law.” This body of law stems from the case law doctrines established by federal court decisions, which have been adopted as the basis of the laws of the U.S. government. While Congress, within the scope of its constitutional powers, has passed many laws that impact the formation and management of federal contracts, the underlying law governing federal contracts is still rooted in the federal common law.

State Law

Subcontracts, on the other hand, are commercial contracts that are governed by the laws of the state in which the contract is formed (or the state selected by the parties). State law governing the sale of goods is covered by the version of the Uniform Commercial Code (UCC) adopted by each state. Unlike the federal common law, which retains more rigid requirements (e.g., contract formation still requires basic rules—that there must exist an offer, an acceptance, consideration, lawful purpose, and capacity of the parties), the UCC states as one of its express purposes to “find” a contract rather than construct impediments to the free formation of a contract according to the parties’ wishes. Thus, it is much simpler and easier for commercial parties to enter into a contract.



The U.S. Government Accountability Office (GAO) will sometimes find that a contract was not formed with the government because it lacked “certainty of terms.” To GAO, this includes what they have referred to as the “PDQ2” formula, or more specifically:

- Price,
- Delivery,
- Quantity, and
- Quality.

For a contract under the UCC, the parties can leave most of those requirements out and the UCC would still “find” a contract, filling in the missing terms using a “reasonable” standard.

UN Convention on the International Sale of Goods

An additional surprise can await those who deal with contractors in other countries. If both countries are signatories to the UN Convention on the International Sale of Goods (UNCISG), there is a third body of law based on international agreement that will apply. While the convention permits the parties to specifically disclaim applicability of the convention, some parties simply believe that including language expressing a choice of specific state law (e.g., “This agreement will be governed by the laws of the state of Virginia”), the problem with this is that, under the U.S. Constitution,

international agreements such as the UNCISG will take precedence over state law and will apply the terms of the convention rather than the UCC provisions of a specific state.

Thus, a prime contractor might find itself bound by a contract that it did not intend and for which the U.S. government will have no responsibility. New government contractors have on occasion failed to understand that a contract does not exist with the government unless and until a properly warranted contracting officer signs the contract on behalf of the United States. If they have made commitments to a subcontractor that would be enforceable under state law or the UNCISG, the state judge or international tribunal will not care about the new contractor’s mistake in understanding. This can be a very costly mistake.

The difference in governing law affects many aspects of contract management. With the prime contract, disputes will be handled in accordance with the Contract Disputes Act. With the subcontract, either party can simply go into a court of appropriate jurisdiction and file suit without any of the constraints imposed under the Contract Disputes Act, such as certification of the claim. In fact, it has occurred where the prime has asserted a claim against the government and lost. The subcontractor then asserts substantially the same claim against the prime, and the prime loses again. Different court; different applicable law; different outcome.

#2 Government Flow Down Clause Applicability

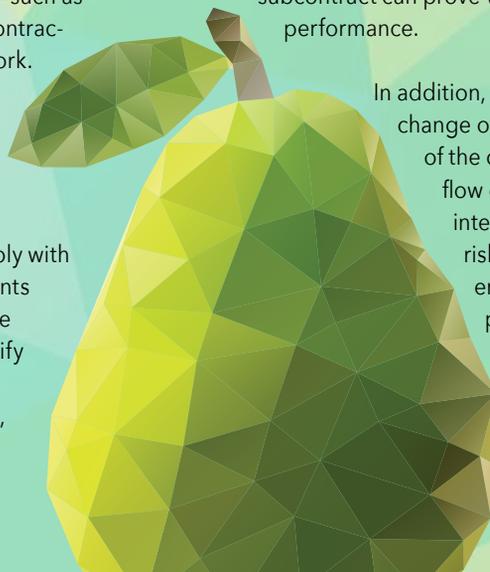
The government includes in its contracts many clauses that are required by a variety of laws, regulations, or executive orders.

Many of these clauses are required to be flowed down to all subcontractors, with even more to be flowed down to those subcontractors that meet certain conditions—such as small business size status, or when the subcontractors are responsible for specific scopes of work.

The prime’s failure to flow the correct and applicable clauses down will not relieve it of responsibility for complete contract compliance with the government prime contract. On occasion, subcontractors have even refused deals so as to *not* have to comply with what they may find to be onerous requirements in government flowdowns. In some cases, the subcontractors may not wish to have to modify their commercial practices, or to have them impacted by government requirements (e.g., cost accounting for unallowable costs).

The UCC, in light of its great flexibility, will allow the parties to include whatever other clauses the parties may agree to, so there is no legal impediment to inserting the flowdowns in the prime’s contract with the subcontractor. Unfortunately, what many primes fail to realize (as do many contracting officers) is that *clauses cost*. The subcontractor will generally accept almost any contract requirement imposed on it, and will then price the cost of compliance into its proposal. In turn, these costs will be passed on to the government via the prime’s contract with the government. Flowing too many clauses, the wrong clauses, or too few clauses into a subcontract can prove very detrimental to the prime contractor’s performance.

In addition, the various flow down requirements change often, and are subject to the circumstances of the contract. Thus, maintaining appropriate flow down requirements can be a very labor-intensive task that could introduce unintended risk onto the subcontract. Therefore, considerable attention to detail is required by the prime contractor in this regard.



#3 Proper Scope Definition and Use of Performance Measurement Tools

As can often be the case, the government's requirements may not be well defined in the prime contract. Whether this is due to the prime contract containing a performance work statement that is simply a statement of objectives, or an award made on the purported basis of "lowest price technically acceptable" (where the "technically acceptable" quality performance standards are not well defined), the fact is that the requirements of the prime contract can often be vague or incomplete.

This emphasizes the distinct need to provide clearly scoped requirements that impose appropriate performance measurement metrics. These metrics must support reporting requirements the government has placed in the prime contract, even when the subcontractor might not be of sufficient size to warrant more sophisticated performance measurement tools. For example, if Earned Value Measurement Systems (EVMS) are imposed on the prime, will the subcontractor have the ability to provide accurate data into the prime's EVMS in order for it to give the government accurate performance data? Conversely, imposing EVMS reporting standards on a subcontractor that has not previously been required to report performance in such a manner could measurably increase the cost of performance. Remember—*clauses cost*.

In most cases, the prime contract's scope should be based on and defined by the use of a work breakdown structure (WBS). The proper use of a WBS should provide a clear division of the work that has been allocated to the various subcontractors, even if the prime contract contains no requirement to have a WBS. By clearly defining the scope and the method by which the performance will be measured, prime contractors can better manage their

integration responsibilities under the prime contract. Any failure to do so will only complicate the prime's responsibilities and possibly cause noncompliance issues. Cost and schedule risk caused by weak requirement definition will fall to the prime when contracting with the government. Using best practices in the management of subcontractors, such as the *mandatory* use of a WBS, can mitigate that risk.



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4 Inapplicability of Many Prime Requirements

If the subcontractor is a small business or is not required to comply with significant government compliance requirements, such as Cost Accounting Standards, this will not relieve the prime of its compliance obligations. This is further compounded when the prime is specifically required to award contracts to small and other preference-holding subcontractors in accordance with a small business subcontract management plan. The small contractors will come to the prime's table with a host of differing measurement and performance systems that will fall to the prime to reconcile.

The formatting of the data required by the government will also flow to the prime as it gathers data from a variety of different subcontractor systems. Even things as simple as government requirements for its contractors to be registered in the System for Award Management (SAM) and to have a Commercial and Government Entity (CAGE) code are inapplicable to most subcontractors who do not also have the role of a prime government contractor.

There is even more latitude for primes to deal with those deemed ineligible for award due to suspension or debarment than the government allows itself. This also passes more risk to the prime. In some cases, the prime can do certain things with subcontractors only if permission from the contracting officer has been obtained. While the old adage says that it is easier to ask forgiveness than to ask permission, this is a very unwise philosophy to use with your subcontractors under a government prime contract.

On the other hand, the prime is well advised to include clauses that are *not* specifically required to be flowed to subcontractors in order to protect the prime's rights in the event of action by the government. For example, the "Termination for Convenience" clause is not a required flow down clause. If the prime contract is terminated for the government's convenience, however, any attempt to terminate the subcontract without such a reservation of rights will, under the UCC, be considered a breach of the subcontract and entitle the subcontractor to a greater measure of damages than the prime is entitled to under its prime contract. These additional costs might not be recoverable from the government. The prime contractor can thus find itself caught between the two contracts governed by different bodies of law (as previously discussed).

It falls to the prime contractor to:

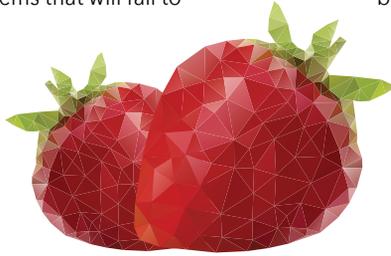
Exclude those clauses as flowdowns that the prime contract requires,

Exclude those clauses that are either not required flowdowns or are otherwise inapplicable to *this* subcontractor, and

Include those specific clauses imposed on the prime that may need to be imposed on the subcontractor depending on how the performance of the contract might proceed.

This is a complicated area that requires specific and well-trained subcontract administration.

As one example of this complexity, consider the situation where a large business awards a subcontract to a small business which in turn awards a subcontract to a large business in an amount above that required for a small business subcontracting plan. If the requirement for such a plan is not initially flowed to the small business subcontractor (since small businesses are exempt from providing such a plan), where is it to find the requirement to pass it on to its large business subcontractor? Or is it not required? Or does such an award even count as a small business award by the prime since such a large piece of the award will actually flow to a large business?



Determining which prime contract requirements must be flowed down to each of the many subcontractors for full compliance with the prime contract can be an interesting exercise in contract administration.



Lack of Authority, as Held by a Contracting Officer

Too often prime contractors take a less-than-careful approach to flowing down requirements from the prime contract to its subcontractors. Many have attempted to flow down the prime contract requirements simply by referring to the clause and then stating that any reference to “government” means the prime contractor, any reference to “contracting officer” means the subcontract administrator, and any reference to “contractor” means the subcontractor. This is simple, but can create additional confusion.

The subcontract administrator does not have the same authority as the representatives of the U.S. government. And remember, the body of law applicable to the two contracts is different. Not only is such an approach lazy and inappropriate contract drafting, but it will be construed against the prime contractor in the case of

a dispute. It is similar to the approach of throwing in every clause and then referring to some of them as “self-deleting.” If they are going to automatically delete themselves, then do not include them in the subcontract. Again—sloppy contract drafting. It is also usually the case that the two parties have vastly different views on which clauses may or may not “self-delete.”

The prime contract cannot assume the full authority of the contracting officer. Using the “Termination for Convenience” clause as an example once again, a broad and unilateral reservation of the right to terminate without paying damages beyond those defined in the clause could be determined by a state court to cause the contract to have never existed since the prime contractor is effectively reserving the right to breach the contract without consequence.

Limiting the termination for convenience rights to those situations where the government has terminated that portion of the work covered by the subcontractor should typically cause a court to enforce its applicability, but this requires more careful drafting of the rights of the parties than simply substituting “subcontract administrator” for “contracting officer.”



Conclusion

There are many other differences between the administration of a government prime contract and the administration of a subcontract under that prime contract. These five only highlight some of the more common problems that a prime contractor will encounter.

Proper administration of the prime contract will require deep involvement and contribution from the subcontractor team. This may include many dozens of subcontractors doing business in different states and using different performance metrics and systems. Many of the prime contract requirements will not apply to the subcontractor, but could apply to the subcontractor’s lower-tier subcontractors. It takes professionally trained subcontract administrators to ensure proper performance that supports the prime contract effort.

Weak subcontract administration, poor drafting of subcontract agreements, inattention to flow-down requirements, and inattention to the rights and responsibilities of the parties—both under the contracts and the applicable body of law—has caused many prime contractors significant cost and performance decrements. Sadly for them, a bit more attention to detail and proper training of their subcontract administrators to these and other risk factors could have avoided those unfortunate consequences. **CM**

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