

The Flowdown of Liability Provisions Under Government Contracts - Prime Contractor to Subcontractor

by Dr. Douglas N. Goetz, CPPM, CF, Ohio Valley Chapter



There has been a lot of debate and argument over the proper flowdown requirements regarding loss of Government property when dealing with the Government Property clause, FAR 52.245-1. The main issue is “Which liability provision should be flowed down by the prime contractor to its subcontractors when Government Property is provided to that subcontractor?” To understand this requirement we have to look at the historical precedents set, the contracting process itself and then provide some concrete guidance to resolve this dilemma.

History Regarding Flowdown of Liability - Pre-2007 FAR

We must first look at the pre-2007 Federal Acquisition Regulation (FAR) Government Property (GP) clauses of 52.245-2(Alt I) and 52.245-5. They essentially stated the identical requirement, under the -2 clause it was Alternate I, paragraph (g)(5) while under the -5 clause it was paragraph (g)(4). The clauses stated,

(5) If the Contractor transfers Government property to the possession and control of a subcontractor, the transfer shall not affect the liability of the Contractor for loss or destruction of, or damage to, the property as set forth above. However, the Contractor shall require the subcontractor to assume the risk of, and be responsible for, any loss or destruction of, or damage to, the property while in the subcontractor's possession or control, except to the extent that the subcontract, with the advance approval of the Contracting Officer, relieves the subcontractor from such liability. In the absence of such approval, the subcontract shall contain appropriate provisions requiring the return of all Government property in as good condition as when received, except for reasonable wear and tear or for its use in accordance with the provisions of the prime contract.

The first requirement set forth in the clause – the contractor was DIRECTED to flow down to the subcontractor the “full” risk of loss – equivalent to regular paragraph (g) in FAR 52.245-2 (Remember, this is the PRE-2007 GP Clause we are dealing with!). But there was an option. Under the pre-2007 FAR GP clauses of 52.245-2(Alt I) and 52.245-5 – there was a allowance for the contractor to come in and ask the Government, “Mother may I” flowdown the limited risk of loss provision? In other words BEFORE the Prime awarded a contract

to a subcontractor – the Prime needed to ask the Government permission, seek approval, seek ADVANCE APPROVAL to flow down a specific clausal requirement – the “limited” risk of loss provision.

It was the GOVERNMENT’S choice, the Government’s decision – by the Contracting Officer, if he/she would ALLOW the Prime to flow the Limited risk of loss to the subcontractor. And this is an important note – it was expected that the Government Contracting Officer would follow the same decision making practice as he/she used when in crafting this contract to determine the APPROPRIATE Risk of Loss provision to use. Yes, surprisingly enough there were detailed guidance, really policy, to help the Contracting Officer make this decision.

45.106 -- Government Property Clauses.

This section prescribes the principal Government property clauses. Other clauses pertaining to Government property are prescribed in Subpart 45.3.

(a)

(b)

(1) The contracting officer shall insert the clause at 52.245-2, Government Property (Fixed-Price Contracts), in solicitations and contracts when a fixed-price contract is contemplated, except as provided in paragraphs (d) and (e) of this section.

(2) If the contract is --

(i) A negotiated fixed-price contract for which prices are not based on an exception at 15.403-1; or

(ii) A fixed-price service contract which is performed primarily on a Government installation, provided the contracting officer determines it to be in the best interest of the Government (see 45.103(b)(4)), the contracting officer shall use the clause with its Alternate I.
(3)....

(c)....

(d)....

(e)....

(f)

(1) The contracting officer shall insert the clause at 52.245-5, Government Property (Cost-Reimbursement, Time-and-Material, or Labor-Hour Contracts), in solicitations and contracts when a cost-reimbursement, time-and-material, or labor-hour contract is contemplated, except as provided in paragraph (d) of this section.

So it provided the Contracting officer a simple rubric – Fixed Price Competitive contracts – FULL risk of loss via FAR 52.245-2. For Fixed Price NEGOTIATED or Cost Reimbursement type contracts – use the LIMITED risk of loss, FAR 52.245-2(Alt. I) or 52.245-5.

From a thought process perspective it really removed any thought. Three simple decisions – What type of contract was being used by the Government – Fixed Price, Fixed Price (Negotiated) or Cost reimbursement?

2007 Government Property Clause - 52.245-1

But with the rewrite of FAR Part 45 and its associated clauses this changed.

One of the SIGNIFICANT changes -- This advance request action was deleted from the 2007 version of the GP Clause (52.245-1). The contractor was now required to take certain actions in regard to the issue of flowdown and liability. In the 2007 and later versions of FAR 52.245-1 GP Clause – paragraph (f)(1)(v) entitled “Subcontractor control” states, “(A) *The Contractor shall award subcontracts that clearly identify items to be provided and the extent of any restrictions or limitations on their use. The Contractor shall ensure appropriate flow down of contract terms and conditions (e.g., extent of liability for loss of Government property).*” (Emphasis added)

The responsibility has been placed upon the PRIME CONTRACTOR to determine the PROPER flowdown requirements INCLUDING for loss of GP. Not an decision made by the Contracting Officer – but rather a well thought out logical decision to be made by the PRIME CONTRACTOR.

There are two lines of thought here that must be addressed:

1. The DECISION making process, i.e., deciding the type of subcontracts to be awarded and
2. The APPLICATION of the liability constructs used by the Government.

Thoughts Behind the Decision Making Process

Contractors do not just willy-nilly go out and award subcontracts! Rather, there should be a well thought out and DOCUMENTED PROCESS used to determine the type of subcontract to be used and

its application. We know this for many reasons but the most prominent reason is that the Government reviews this process – through a Contractor Purchasing System Review – a CPSR.

CPSRs are discussed in FAR Part 44.3 as well as the DFARS equivalent. The CPSR reviews that the contractor, in awarding subcontracts and purchase orders, meets certain criteria – some Government specific, while others may be viewed as the actions taken by prudent person in the conduct of competitive business.

Even more specificity is provided in the DFARS clause regarding Contractor Purchasing Systems at 252.244-7001, Contractor Purchasing System Administration. Some of the System Criteria included within paragraph (c) of that clause require the contractor to:

(1) *Have an adequate system description including policies, procedures, and purchasing practices that comply with the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS);*

(2) *Ensure that all applicable purchase orders and subcontracts contain all flowdown clauses, including terms and conditions and any other clauses needed to carry out the requirements of the prime contract;*

...

(8) *Evaluate price, quality, delivery, technical capabilities, and financial capabilities of competing vendors to ensure fair and reasonable prices;*

(9) *Require management level justification and adequate cost or price analysis, as applicable, for any sole or single source award;*

(10) *Perform timely and adequate cost or price analysis and technical evaluation for each subcontractor and supplier proposal or quote to ensure fair and reasonable subcontract prices;*

If you really analyze these requirements – it appears that the Government is really telling the contractor to emulate the Government in ITS buying decisions. If we are to apply these and other FAR and DFARS flowdown requirements the intent is essentially to require the prime contractor to behave as the Government would under similar circumstances. Therefore, when we use the sentence “The Contractor shall ensure appropriate flow down of contract terms and conditions...” in FAR 52.245-1(f)(1)(v) though we do not define the word

“appropriate” we can rationalize its meaning by examining the intent of contractor purchasing system requirements, FAR 44.303 gives use those requirements, i.e., performing market research, ensuring adequate price competition, obtaining certified cost and pricing data (when applicable), evaluating sub-contractor responsibility, etc.

If we go one step further, DFARS 252.244-7001 Contractor Purchasing System Administration requires contractors in paragraph (c)(2) to “ensure that all applicable purchaser orders and subcontracts contain all flowdown clauses, including terms and conditions and any other clauses need to carry out the requirements of the prime contract.”

If the prime contractor does these actions properly it will lead to the selection of the PROPER flow down requirement.

Ok, let me help you with MY analysis of the flow down requirements. I believe that we can BROADLY generalize flowdown requirements into the proper application by NEGOTIATED versus COMPETITIVE subcontracts. Why do I say this? Let’s go back to the Government Policy on when IT uses the full risk of loss versus the limited risk of loss.

FAR 45.104 and 45.107 provide us the policy and direction regarding liability and for using the Government Property clauses, respectively.

FAR 45.104 states, 45.104 -- Responsibility and Liability for Government Property.

(a) Generally, contractors are not held liable for loss of Government property under the following types of contracts:

- (1) Cost-reimbursement contracts.*
- (2) Time-and-material contracts.*
- (3) Labor-hour contracts.*
- (4) Fixed-price contracts awarded on the basis of submission of certified cost or pricing data.*

The above types of contracts use the LIMITED RISK OF LOSS PROVISION where the Government, generally, does NOT hold the contract liable for loss of Government Property. That leaves us with a question – under what type of contract DOES the Government hold the contractor liable for the loss of Government Property?

Simple answer – by process of elimination – Fixed Price Competitive contracts.

This takes us to FAR 45.107 which addresses which Government Property clause to use. It states,

45.107 -- Contract Clauses.

(a)(1) Except as provided in paragraph (d) of this section, the contracting officer shall insert the clause at 52.245-1, Government Property, in—

(i) All cost reimbursement and time-and-material type solicitation and contracts, and labor-hour solicitations when property is expected to be furnished for the labor-hour contracts.

(ii) Fixed-price solicitations and contracts when the Government will provide Government property.

(iii) Contracts or modifications awarded under FAR Part 12 procedures where Government property that exceeds the simplified acquisition threshold, as defined in FAR 2.101, is furnished or where the contractor is directed to acquire property for use under the contract that is titled in the Government.

(2) The contracting officer shall use the clause with its Alternate I in contracts other than those identified in FAR 45.104(a), Responsibility and Liability for Government Property.

The CRITICAL Part here is paragraph (a)(2) – which tells the reader to refer back to 45.104 – addressing the types of contracts – and in this case, when to use the FULL RISK OF LOSS.

Now there are other variables that come into play in this decision making process – things like Cost Accounting Standards (CAS), Cost Principles, Insurance on Government Property, the issue of the Government generally acting as a self-insurer for the loss of Government Property under certain conditions.

Fundamentally it comes down to the issue of COMPETITIVE versus NEGOTIATED contracts, their cost and pricing issues, the allowability of insurance, and good contracting practices.

Though there have been many opinions regarding the correctness of my interpretation. The Defense Contract Management Agency (DCMA) has just recently issued a Policy Letter regarding this issue.

I have included it in this article to provide support for my analysis and the flowcharts that follow.



DEFENSE CONTRACT MANAGEMENT AGENCY

3901 A AVENUE, BUILDING 10500
FORT LEE, VA 23801-1809

SEP 10 2012

MEMORANDUM FOR CMO COMMANDERS/DIRECTORS, DCMAN, DCMA INTERNATIONAL, AND DCMA SPECIAL PROGRAMS

SUBJECT: Proper Flowdown of Government Property Liability Requirements

There continue to be questions regarding proper flowdown of Government property liability requirements from a prime contractor to its subcontractors. At issue is determining proper flowdown requirements by the prime and the extent of Government oversight to ensure compliance. The Federal Acquisition Regulation (FAR) Part 45 governs contractor responsibility and liability for Government property. Specifically, FAR Subpart 45.104(c) states that prime contractors are not relieved of any responsibility to the Government the prime may have under the terms of the prime contract.

Pursuant to the FAR clause at 52.245-1(f)(1)(v)(A), contractors are required to award subcontracts that clearly identify the property to be provided and shall ensure appropriate flowdown of contract terms and conditions. Paragraph (B) of that same clause requires prime contractors to ensure their subcontracts are properly administered and reviews periodically performed to determine the adequacy of subcontractor property management systems. Contractor property management procedures must define how this will be accomplished; it is the responsibility of DCMA property administrators to provide effective oversight to ensure compliance.

Under FAR Subpart 45.104, contractors are generally not held liable for loss, damage, destruction or theft occurring under the following contract types where the Government assumes the risk of Government property loss, theft, damage or destruction:

- Cost-reimbursement contracts
- Time-and-material contracts
- Labor-hour contracts
- Fixed-price contracts awarded on the basis of submission of certified cost or pricing data

In November 2011, a final rule amended Defense Federal Acquisition Regulation Supplement (DFARS) Subpart 245.104 by adding negotiated fixed-price contracts "not awarded on the basis of submission of certified cost or pricing data." The Government in most cases self-insures against property loss—with full liability invoked on fixed-price competitively awarded contracts. There are some exceptions to this policy; for example, DFARS clause 252.228-7001, "Ground-and-Flight Risk," contains a number of exclusions to the Government's assumption of risk. The specific clauses of the contract shall govern. Therefore, it is important for contracting officers and property administrators to review the terms and conditions of each contract before making determinations on liability.

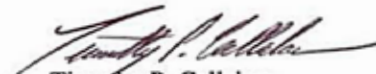
Based on the above, as a general rule, prime contractors are required to flow down limited liability in the majority of their negotiated subcontracts. In contrast, competitively awarded subcontracts should require full liability. Such practice mirrors the Government's general procurement policy in the majority of cases. However, industry (like the Government) often considers other factors, including commercial practices when awarding commercial subcontracts, supplier risk, cost, schedule, and performance criteria. This may be acceptable depending on the circumstances, e.g., as established practices properly disclosed in the prime contractor's approved subcontracting plan, purchasing or accounting system procedure, or otherwise negotiated into the contract.

Notwithstanding the FAR language on Government property liability or the type of subcontract or flowdown language, the contractor still has a duty to perform and comply with contract terms and conditions. As stated above, FAR clause 52.245-1(b)(2) requires contractors to have a system of internal controls to manage (control, use, preserve, protect, repair, and maintain) Government property in its possession. This requirement applies to all Government property under the contractor's accountability, stewardship, possession or control, including its vendors or subcontractors.

DFARS Subpart 244.3 - Contractors' Purchasing System Reviews (CPSR), requires contracting officers to determine the acceptability of a contractor's purchasing system, approve or disapprove the system, and pursue correction of significant deficiencies cited by the functional specialist. The DFARS clause 252.244-7001 requires contractors to "establish and maintain policies and procedures to ensure purchase orders and subcontracts contain mandatory and applicable flowdown clauses, as required by the FAR and DFARS, including terms and conditions required by the prime contract and any clauses required to carry out the requirements of the prime contract." Should this not occur, the Contracting Officer can invoke all rights and remedies.

As stated in DCMA's current Contract Property Management Instruction, the assigned property administrator has the primary responsibility for ensuring proper flowdown of liability requirements. Contracting officers should be alert to the potential impact of property management system analyses on current or future CPSR reviews. We will consider potential FAR and DFARS and/or needed policy changes as we go forward.

Please direct any questions to Tom Ruckdaschel, Deputy Director, Government Property Policy, at 804-734-0505 or via e-mail at tom.ruckdaschel@dcma.mil.



Timothy P. Callahan
Executive Director
Contracts

So, to try and wrap all of these technical variable into one small package I have included here are a number of charts that MAY help you with this analysis.

Though this is an extremely complex decision tree – it is hoped that the property professional dealing with Government property in the possession of the contractor can work his or her way through the tables – and understand its background and application.

Oh, and a few closing thoughts – if these actions are NOT done properly they may lead to increased costs for the Government or for the contractor. Specifically, if the limited risk of loss provision is flowed down incorrectly – the Government may assume more risk than necessary and upon loss of Government property would incur costs for which it would otherwise NOT be responsible. By the same token if the full risk of loss were flowed down improperly the contractor may incur costs for insurance added into the price of the subcontract which it should not have to bear.

End result – it is critical that BOTH Government and industry exert all due diligence to ensure that the proper terms and conditions are properly applied – ESPECIALLY when dealing with the liability for loss of Government property and its flowdown to subcontractors! ■

BIOGRAPHY

Dr. Douglas N. Goetz, CPPM, CF, an accomplished educator, dynamic speaker, researcher and author whose reputation precedes him as a now retired professor at the Air Force Institute of Technology (AFIT) and the Defense Acquisition University (DAU). Upon his retirement from DAU he founded and is President of GP Consultants, LLC, a much in demand firm that provides technical consulting excellence in Contract Property Management to both Government and industry entities. A member of NPMA for over 30 years, he served as National Editor and now Editor Emeritus of The Property Professional, as well as multiple terms as a member of the NPMA Board of Advisors. He has received numerous awards including the Jack E. Griffiths Memorial Award as the NPMA Property Person of the Year, the NPMA Lifetime Achievement Award, and the Department of Defense Civilian Meritorious Service Award. He is listed in Marquis' "Who's Who in American Education" and "Who's Who in America."

FIRST FAR APPLICATION

FIXED PRICE (COMPETITIVE)
PRIME CONTRACT/CONTRACTOR
WITH **NO**
Requirement for a Cert of Current Cost and Pricing Data)
WITH GOVERNMENT PROPERTY CLAUSE
Of FAR 52.245-1 (Alternate I)
FULL RISK OF LOSS

REGARDLESS OF THE PRICING ARRANGEMENT
OF THE SUBCONTRACT
PRIME WOULD AUTOMATICALLY
FLOW DOWN THE
FULL RISK OF LOSS
TO ITS
SUBCONTRACTORS AND VENDORS
WHEN
GP IS PROVIDED TO SUB
+
GP MANAGEMENT REQUIREMENTS.

Why is it simple? IF Prime has **Full** risk of loss –
Sub should have **Full** Risk of Loss!
NOTE: If Prime flows down LIMITED Risk of Loss to its sub
-- A RARITY -- it does NOT effect the liability of the prime.
The Prime is still liable.

SECOND FAR APPLICATION

1. **COST REIMBURSEMENT NEGOTIATED** or
2. **FIXED PRICE NEGOTIATED**
PRIME CONTRACT/CONTRACTOR
EXCEEDING \$700,000
(Requiring a Cert of Current Cost and Pricing Data)
AND FAR 52.215-12*
AND
PRIME HAS GOVERNMENT PROPERTY CLAUSE
Of FAR 52.245-1
LIMITED RISK OF LOSS

Automatically Flow Down the
Limited Risk of Loss
GP Provision

COST REIMBURSEMENT
SUBCONTRACTOR
Being awarded a
NEGOTIATED subcontract
Exceeding \$700,000
AND
Containing 52.215-12*
AND
Providing Government
Property +
GP MANAGEMENT
REQUIREMENTS

FIXED PRICE
SUBCONTRACTOR
Being awarded a
NEGOTIATED subcontract
Exceeding \$700,000
AND
Containing 52.215-12*
AND
Providing Government
Property +
GP MANAGEMENT
REQUIREMENTS

* NOTE: There are exceptions at 15.403-1 where this clause is **NOT** required.

THIRD FAR APPLICATION

1. COST REIMBURSEMENT **NEGOTIATED** or
2. FIXED PRICE **NEGOTIATED**
PRIME CONTRACT/CONTRACTOR
EXCEEDING \$700,000
(Requiring a Cert of Current Cost and Pricing Data)
AND FAR 52.215-12* or
AND (For all above)
WITH GOVERNMENT PROPERTY CLAUSE
Of FAR 52.245-1
LIMITED RISK OF LOSS

Flow Down
The **FULL Risk of Loss**
GP Provision to a

FIXED PRICE
SUBCONTRACTOR
Being awarded a
COMPETITIVE subcontract
Regardless of \$ Value
AND
Providing Government Property +
GP MANAGEMENT REQUIREMENTS

* NOTE: There are exceptions at 15.403-1 where this clause is **NOT** required.

FIFTH APPLICATION FOR **DOD ONLY**

1. FIXED PRICE **NEGOTIATED**
PRIME CONTRACT/CONTRACTOR
(**NOT** REQUIRING a Cert of Current Cost and Pricing Data
UNDER \$700,000)
SEE DFARS 245.107 for Policy
[(6) For negotiated fixed-price contracts awarded on a basis other than submission of
certified cost or pricing data for which Government property is provided,
use the clause at FAR 52.245-1, Government Property, **without** its Alternate I.]
AND
WITH GOVERNMENT PROPERTY CLAUSE
Of FAR 52.245-1
LIMITED RISK OF LOSS

In Awarding a
FIXED PRICE **COMPETITIVE**
Contract, PRIME **WOULD**
FLOW DOWN THE
FULL RISK OF LOSS
TO ITS
SUBS and VENDORS
WHEN
GP IS PROVIDED TO SUB
+
GP MANAGEMENT
REQUIREMENTS.

In Awarding a
FIXED PRICE **NEGOTIATED**
Contract, PRIME **MAY***
FLOW DOWN
LIMITED RISK OF LOSS
TO ITS
SUBS and VENDORS
WHEN
GP IS PROVIDED TO SUB
+
GP MANAGEMENT
REQUIREMENTS

* Prime **MAY** flow down Limited Risk Of Loss if... Prime requires sub to exclude insurance for GP. See 31.205-19 for allowability of insurance costs. If Subktr is unable/unwilling to exclude insurance then Prime would flow down full!

FOURTH FAR APPLICATION

1. COST REIMBURSEMENT **NEGOTIATED**
PRIME CONTRACT/CONTRACTOR **UNDER \$700,000**
(**NOT** Requiring a Cert of Current Cost and Pricing Data)
AND WITH GOVERNMENT PROPERTY CLAUSE
Of FAR 52.245-1
LIMITED RISK OF LOSS

In Awarding a FIXED PRICE **COMPETITIVE** Contract,
PRIME **WOULD** FLOW DOWN **FULL RISK OF LOSS**
TO ITS SUBS and VENDORS WHEN GP
IS PROVIDED TO SUB
+ GP MANAGEMENT REQUIREMENTS.

In Awarding a FIXED PRICE **NEGOTIATED** Contract,
PRIME **MAY*** FLOW DOWN **LIMITED RISK OF LOSS**
TO ITS SUBS and VENDORS WHEN GP
IS PROVIDED TO SUB
+ GP MANAGEMENT REQUIREMENTS
NOTE: FAR 31.2 Incorporated by Reference

In Awarding a COST REIMBURSEMENT **NEGOTIATED**
Contract,
PRIME **MAY*** FLOW DOWN **LIMITED RISK OF LOSS**
TO ITS SUBS and VENDORS WHEN GP
IS PROVIDED TO SUB
+ GP MANAGEMENT REQUIREMENTS
NOTE: FAR 31.2 Incorporated by Reference

* Prime **MAY** flow down Limited Risk Of Loss if... Prime requires sub to exclude insurance for GP. See 31.205-19 for allowability of insurance costs. If Subktr is unable/unwilling to exclude insurance then Prime would flow down full!