PCI Supply Chain Symposium:
Mandatory FAR Flow-Down Clauses and Best Practices
(Updated Through January 2017)

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Goals

- Provide relevant information for performance of US Government contracts (prime & sub)
- Provide a framework for evaluating flow-down requirements
  - Enable prime contractors to identify contract requirements that must, and others that should, be included in subcontracts
  - Equip subcontractors with the information necessary to effectively negotiate
- Identify new, substantive flow-down issues
- Not a comprehensive list all flow-downs
Overview

- Key Concepts And Definitions
  - From the Federal Acquisition Regulation (FAR)

- Mandatory Flow-downs
  - Commercial items
  - Non-commercial items
  - Services

- Recommended FAR Flow-downs / “Gap Filling”

- Limitation of Liability Hypothetical
What Is A Subcontract?

- 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 modifications to purchase orders. FAR 44.101

- “Subcontractor” means any supplier, distributor, vendor, or firm that furnishes supplies or services to or for a prime contractor or another subcontractor. FAR 44.101
What Are Flow-Down Provisions?

- USG prime contract clauses inserted into a subcontract
- Includes clauses from the FAR and agency supplements (e.g., DFARS)
- These “flow-down” the responsibilities of the prime to the subcontractor
- Can significantly impact the obligations and risks for performing the subcontract
Mandatory Flow-downs

- Specifically require the prime to include them in subcontracts
- Not negotiable
- E.g., Equal Opportunity Employment clauses

Non-Mandatory Flow-downs

- Prime contract does not explicitly require they be included in subcontracts
- Yet, Prime must ensure subcontractor compliance with Prime contract requirements
- Several clauses should also be flowed-down even if not required (e.g., Changes and Termination for Convenience clauses)
Why Do Flow-Downs Matter?

**Prime Contractor**
- Meet contract requirements
- USG consent to subcontract (FAR Subpart 44.2) & purchasing system approval (FAR Subpart 44.3)
- Maximize cost recovery by ensuring cost reasonableness
- Manage/allocate performance uncertainties and risk

**Subcontractor**
- Ability to participate in huge federal marketplace
- Develop past performance history
- Minimize exposure to prime contractor risks
- Ensure company can meet compliance obligations
What If A Mandatory Clause Is Not Flowed-Down?

Prime Contractor

- In breach of USG Prime contract
- Can be subject to numerous remedies, such as:
  - Withholding of payments,
  - Termination of contract, and
  - Suspension or debarment

Subcontractor

- Under current trend to extend the “Christian Doctrine,” subs becoming subject to USG requirements even if they are not in subcontract
    - Incorporated mandatory socio-economic requirements into subcontract even though not in subcontract
    - Based on *G.L. Christian & Associates v. United States*, 312 F.2d 418, 426 (Ct. Cl. 1963) finding contract requirements reflecting a “significant or deeply ingrained strand of public procurement policy” apply to government contracts even if requirements not in contract
- Before *UPMC Braddock*, Christian Doctrine only applied to Prime contracts
How Can I Tell When A Clause Is Required To Be Flowed-Down To A Subcontract?

1. Read the clause—it will specify
   - Some clauses must be flowed-down verbatim
     - “Contractor shall include this clause in subcontracts”
   - Other clauses can be modified
     - “Contractor shall include the substance of this clause in subcontracts”

2. Read the text reference that prescribes use of the clause (e.g., conditions or threshold)
Which Clauses are Required to be Flowed-Down Depend on the Type and Value of the Contract:

- **Type of goods or services**
  - Commercial Items
  - Non-Commercial Items

- **Prime and subcontract payment terms**
  - Fixed price
  - Cost reimbursement
  - Time and materials

- **Contract value**
  - OFCCP Socio-Economic Clauses: $10,000
  - Simplified Acquisition Threshold: $150,000 (FAR 2.101)
  - TINA Threshold: $750,000
What Is A Commercial Item? FAR 2.101

- Generally, any item that is of a type customarily used by the general public, and has been sold, leased, or licensed to the general public, or

- Any item that would satisfy a criterion above, but for-
  
  (i) Modifications of a type customarily available in the commercial marketplace; or
  
  (ii) Minor modifications of a type not customarily available in the commercial marketplace made to meet Federal Government requirements
# Mandatory Flow-Downs For Commercial-Items

## Eighteen “Must Haves” FAR 52.244-6(c)(1) (Jan. 2017)

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<thead>
<tr>
<th></th>
<th>FAR Code</th>
<th>Description</th>
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<tbody>
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<td>1</td>
<td>52.203-13</td>
<td>Code of Business Ethics and Conduct</td>
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<td>Whistleblower Protections Under the American Recovery and Reinvestment Act</td>
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<td>52.232-40</td>
<td>Providing Accelerated Payments to Small Business Subcontractors</td>
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<td>18</td>
<td>52.247-64</td>
<td>Preference for Privately Owned U.S.-Flag Commercial Vessels</td>
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</table>
Mandatory Flow-Downs For Commercial Items (cont’d)

- **(1) Code of Business Ethics and Conduct, FAR 52.203-13 (Oct. 2015)**
  - Written code of business ethics and conduct, compliance program, and an internal control system that facilitates timely disclosures to the USG of credible evidence of criminal or civil fraud violations
  - Subcontracts in excess of $5,500,000 and performance period of more than 120 days

  - Post notice of employee rights to whistleblower protection, and the remedies that apply in the case of retaliation
Mandatory Flow-Downs For Commercial Items (cont’d)

- (3) **Basic Safeguarding of Covered Contractor Information Systems**, FAR 52.204-21 (Jun. 2016)
  - Apply basic safeguarding requirements and procedures to protect covered contractor information systems (IS), including:
    - limit access to IS based on specific criteria, and authenticate identities of those granted access
    - control information posted on publicly accessible IS
    - separate publicly accessible IS
    - sanitize or destroy system media before disposal or release for reuse
    - monitor, control and protect communications
    - identify, report, and correct IS flaws in a timely manner
    - protect against malicious code
    - perform periodic scans of IS
(4) Utilization of Small Business Concerns, FAR 52.219-8 (Nov. 2016)

- Agree to carry out Government’s policy of encouraging participation of small business concerns in performing USG contracts
- Nov. 2016 revision includes additional criteria for primes to determine if subs are small.
- Threshold: $150,000 (simplified acquisition threshold)

(5) Prohibition of Segregated Facilities, FAR 52.222-21 (Apr. 2015)

- Prohibits segregation of facilities based on race, color, religion, sex, sexual orientation, gender identity, or national origin
- Trigger threshold: $10,000
Mandatory Flow-Downs For Commercial Items (cont’d)

- **(6) Equal Opportunity**, FAR 52.222-26 (Sept. 2016)
  - Prohibits discrimination against any employee/applicant on the basis of race, color, religion, sex, **sexual orientation, gender identity**, or national origin and requires employers to follow an affirmative, written action plan to ensure compliance (emphasis added)
  - Trigger threshold: $10,000

  - Trigger threshold: $150,000

  - Prohibits discrimination on the basis of disability, and requires affirmative action to employ and advance in employment qualified individuals with disabilities
  - Trigger threshold: $15,000
(9) Employment Reports on Veterans, FAR 52.222-37 (Feb. 2016)
- Requires that USG contractors and subcontractors report at least annually, no later than September 30 of each year, on the total number of employees who are veterans and the total number of new hires and the max/min number of employees at each hiring location during the reporting period
- Trigger threshold: $150,000

(10) Notification of Employee Rights Under the National Labor Relations Act, FAR 52.222-40 (Dec. 2010)
- Requires employers to conspicuously post employees’ rights under the National Labor Relations Act
- Trigger threshold: $10,000
Mandatory Flow-Downs For Commercial Items (cont’d)

- (11) Combat Trafficking in Persons, FAR 52.222-50 (Mar 2015)
  - Updated in 2015 to expand the definition of trafficking, and include requirement for notification to USG of violations of clause
  - It also requires a compliance program for contracts and subcontracts for supplies, other than commercially available off-the-shelf items, acquired outside the United States, or services to be performed outside the United States, which requires employee training and posting of a written compliance plan, process for employees to anonymously report violations, and annual compliance certifications
  - Trigger threshold: $500,000
Mandatory Flow-Downs For Commercial Items (cont’d)

  - Clause requiring contractor and subcontractors to pay workers, while performing in the United States, and performing on, or in connection with a USG contract, a minimum hourly wage rate annually adjusted to meet the Secretary of Labor’s annual E.O. minimum wage determination
    - Currently $10.20 per hour as of Jan. 1, 2017
    - Applies to all contracts – No threshold
Mandatory Flow-Downs For Commercial Items (cont’d)

- (13)Compliance with Labor Laws (Executive Order 13673), FAR 52.222-59 (Oct. 2016)
  - Requires contractors to disclose new labor law decisions in SAM semiannually
  - For subcontracts greater than $500,000 for other than COTS items, contractors must also consider labor law violation information when determining subcontractor responsibility
  - Trigger threshold: $500,000
  - NOTE: This provision is currently enjoined indefinitely per a court order issued October 24, 2016. The enjoined section will become effective immediately if the court terminates the injunction.
Mandatory Flow-Downs For Commercial Items (cont’d)

- **(14) Paycheck Transparency (Executive Order 13673), FAR 52.222-60** (Oct. 2016)
  - Requires contractors to provide a wage statement document (e.g. a pay stub) to all individuals subject to the Fair Labor Standards Act, the Davis Bacon Act, and the Service Contract Act
  - Trigger threshold: $500,000

  - Requires contractors to provide sick leave and allow employees to earn not less than 1 hour of paid sick leave for every 30 hours worked
  - Contractors must keep records with respect to wages and accrued sick leave for employees
  - Failure to comply may result in withholding, contract termination, suspension and/or debarment
  - Applies to contracts subject to the Service Contract Act or the Davis Bacon Act
- Requires training, human resource vetting, arms control, and reporting of situations where firearms were used
- Contractors required to cooperate with Government-authorized investigations

- Applies if payments are accelerated by USG

(18) Preference for Privately Owned U.S.-Flag Commercial Vessels, FAR 52.247-64 (Feb. 2006)
- Requires use of a U.S. flagged commercial vessel for shipment of at least 50% of gross tonnage whenever transporting via ocean vessels
Mandatory Flow-Downs For Non-Commercial Items

- Same Eighteen Mandatory Flow-Downs for Commercial Items, PLUS (at least) six more (depending on the type of contract):
  - (1) **Anti-Kickback Procedures**, FAR 52.203-7
    - Prohibits contractors from providing any kickback or soliciting or attempting to accept any kickback
    - Trigger threshold: $150,000
  - (2) **Limitation on Payments to Influence Certain Federal Transactions**, FAR 52.203-12
    - Prohibits contractors from using appropriated funds to pay any person for influencing or attempting to influence an officer or employee of any agency, a Member of Congress, an officer or employee of Congress, or an employee of a Member of Congress in connection with the award of the contract
    - Trigger threshold: $150,000
Mandatory Flow-Downs For Non-Commercial Items (cont’d)

- (3) **Audit and Records—Negotiation**, FAR 52.215-2
  - Applies to subcontracts that exceed the simplified acquisition threshold, and are cost-reimbursement, time-and-materials, labor-hour, or price-re-determinable types; or subcontracts for which cost and pricing data are required

- (4) **Price Reduction for Defective Certified Cost or Pricing Data**, FAR 52.215-10
  - Non-commercial item subcontracts above the TINA threshold, $750,000

- (5) **Subcontractor Certified Cost or Pricing Data**, FAR 52.215-12
  - In subcontracts that require FAR 52.215-10

- (6) **Patent Rights—Ownership by the Contractor**, FAR 52.227-11
  - In subcontracts for experimental, developmental, or research work
  - Subcontractor has rights and obligations of contractor in clause; contractor shall not obtain subcontractor’s subject inventions
Mandatory Flow-Downs For Service Subcontracts Other Than Construction

- Same Eighteen Mandatory Flow-Downs for Commercial Items, PLUS six applicable to non-commercial items, PLUS three more:
  - (1) **Accident Prevention**, FAR 52.236-13
    - Provide and maintain work environments and procedures that:
      - Safeguards the public and Government personnel, property, materials, supplies, and equipment
      - Avoids interruption of Government operations
      - Controls costs in performance of contract
Mandatory Flow-Downs for Service Subcontracts Other than Construction (cont’d)

- **(2) Service Contract Labor Standards**, FAR 52.222-41
  - Requires contractor to pay all service employees no less than the wage rates and fringe benefits determined by the Secretary of Labor
  - If no wage rate is established, contractor may not pay less than the minimum wage established by the Fair Labor Standards Act of 1938
  - Disputes about labor standard requirements are resolved through procedures established by the Department of Labor in 29 C.F.R. Parts 4, 6, and 8, and not the Disputes clauses of the contract

- **(3) Preventing Personal Conflicts of Interest for Contractor Employees Performing Acquisition Functions**: FAR 52.203-16
  - Procedures to screen employees that will perform inherently governmental functions on service contracts
Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down

- Organizational and Consultant Conflicts of Interest, FAR Subpart 9.5
  - Contractor may be disqualified from acquisitions for organizational conflicts of interest (“OCI”) based on unequal access to information, biased ground rules, or impaired objectivity
  - Proposed FAR Rule would revamp current OCI rules and allow agencies to accept impaired objectivity conflicts that do not create unfair competitive advantage (finalization pending)
Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down (*cont’d*)

- Reporting Executive Compensation and First-Tier Subcontract Awards, FAR 52.204-10
  - Requires contractor to report income of top five compensated executives for first-tier subcontract awards of $25,000 or more

- Termination for Convenience (FAR Part 49)
  - Allows prime contractor to terminate the subcontract should the Government terminate fixed-price or cost-type prime contracts
Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down *(cont’d)*

- **Changes, FAR Part 43**
  - Allows prime contractor to make changes to subcontract requirements should the Government make changes to the prime’s requirements

- **Protest After Award, FAR Subpart 33.1**
  - Allows prime contractor to issue stop work order to the subcontractor
Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down (cont’d)

- Disputes Clause, FAR Subpart 33.2
  - Puts subcontractor on notice of disputes process, including the requirement to submit a certification of a claim
  - Or, alternate disputes resolution mechanisms may be desirable when claims are not of the pass-through variety
Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down (cont’d)

- Data Rights, FAR 52.227-14
  - Primes required to obtain from subcontractors “all data and rights therein necessary to fulfill the . . . Contract”
- How to fill gaps? . . . Consider the FAR, FAR Part 12, and UCC
Flow-Down Best Practices – Prime Contractor

Understand your contract – paying close attention to clauses incorporated by reference (FAR, DFARS, etc. clauses)

Create a matrix that identifies flow-down requirements specific to each contract based on subcontract value and type

Incorporate non-mandatory clauses that are necessary to mitigate risk and ensure subcontractor compliance

Monitor subcontractor compliance

Monitor new clauses in contract mods, and modify subcontracts to flow-down
Beware of language incorporating all prime contract requirements

Know which flow-downs are mandatory

These are non-negotiable, so don’t waste time on them

Potentially push back on non-mandatory flow-downs

Monitor new clauses in modifications
<table>
<thead>
<tr>
<th></th>
<th>UCC</th>
<th>FAR</th>
<th>FAR Part 12: Commercial Items</th>
</tr>
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<tbody>
<tr>
<td><strong>Warranties</strong></td>
<td>• 2-313: Express Warranties</td>
<td>• 46.706: All warranties must be express</td>
<td>• 52.212-4(o): Warrants Merchantability and Fitness</td>
</tr>
<tr>
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<td>• 2-314: Implied Warranty of Merchantability</td>
<td>• 52.246-17 and -18: Contain warranties for simple and complex items</td>
<td>• Accommodates Commercial Tendencies</td>
</tr>
<tr>
<td></td>
<td>• 2-315: Implied Warranty (Fitness for Particular Purpose)</td>
<td>• 52.246-17 and -18: Contain warranties for simple and complex items</td>
<td>• Negotiable</td>
</tr>
<tr>
<td><strong>Title Passage and Risk of Loss</strong></td>
<td>• 2-401: Title passes when seller completes delivery</td>
<td>• Driven by payment types: progress v. performance-based</td>
<td>• 52.212-4(j) and (n): Both title and risk are negotiable</td>
</tr>
<tr>
<td></td>
<td>• 2-509: Risk of loss passes on delivery</td>
<td>• 46.505(a): Title passes on formal acceptance</td>
<td>• Fallback position—FAR assumptions</td>
</tr>
<tr>
<td><strong>Audit Rights</strong></td>
<td>• No coverage</td>
<td>• 46.505(b): Risk of loss upon delivery if FOB origin; upon acceptance if FOB destination</td>
<td>• 52.212-5(d): If competitive, exceeds simplified threshold and excludes 52.215-2:</td>
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<tr>
<td></td>
<td></td>
<td>• Government Property</td>
<td>• Until 3 years from final payment</td>
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<td>• Access to “directly pertinent” records involving transaction related to the contract</td>
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<tr>
<td><strong>Indemnification/Limitation of Liability</strong></td>
<td>• Allocation of risks entirely negotiable</td>
<td>• Subpart 46.8: Contractor relieved of liability if loss or damage occurs after acceptance</td>
<td>• No liability for consequential damages</td>
</tr>
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<td></td>
<td>• Avoid “betting the company”</td>
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**Notes:**
- **UCC** refers to the Uniform Commercial Code.
- **FAR** refers to the Federal Acquisition Regulation.
- **FAR Part 12** pertains to Commercial Items.
Limitation Of Liability Case Study: The Satellite Manufacturer

FACTS:

“Satellites Are Us” supplies satellites to commercial (television) and Government (weather research) customers. Satellites Are Us purchases a critical electronic component from “Failure, Inc.” During acceptance testing of the satellites by Satellites Are Us, an electronic component supplied by Failure, Inc. systemically fails. The satellites cannot operate without this electronic component.
Satellites Are Us Will Incur The Following Costs

- Cost to remove the electronic components from the satellites
- Cost to ship the components to Failure, Inc. for investigation
- Cost to investigate the failure
- Cost to repair or re-design the electronic components
- Component level testing
- Cost to ship repaired or re-designed components back to Satellites Are Us
Satellites Are Us Will Incur The Following Costs (cont’d)

- Cost expended by Satellites Are Us to retest the Government and commercial satellites
- Potential damages, including possible liquidated damages, payable to the commercial satellite customers caused by loss of revenue from delayed launch
- Payment to Government customers if satellite contracts are terminated for default; or damages for delayed launch
Limitation of Liability:

“The relief that may be awarded pursuant to any dispute under this contract may not exceed direct and actual, compensatory damages. In no event may special, incidental, consequential or punitive damages be awarded.”
Direct Damages: Not Defined In UCC

UCC § 2-714: Buyer’s Damages for Breach

(1) Where the buyer has accepted goods and given notification (subsection (3) of Section 2-607) he may recover as damages for any non-conformity of tender the loss resulting in the ordinary course of events from the seller’s breach as determined in any manner which is reasonable.

(2) The measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount.

(3) In a proper case any incidental and consequential damages under the next section may also be covered.
Incidental And Consequential Damages

UCC § 2-715: Buyer's Incidental and Consequential Damages

(1) Incidental damages resulting from the seller's breach include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.

(2) Consequential damages resulting from the seller's breach include:

(a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and

(b) injury to person or property proximately resulting from any breach of warranty.
Case Law Views: Direct Damages

- **Cato Equipment Co. Inc. v. Matthews**, 372 S.E.2d 872 (N.C. Ct. App. 1988): The measure of damages for breach of warranty is the difference at the time of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted.

What Are “Actual, Compensatory” Damages?

- **Wright-Schuchart, Inc. v. Cooper Industries**, 40 F.3d 1247 (9th Cir. 1994) (Alaska Law): Action by buyer against seller of non-conforming specialty goods
  - Clause: “actual, compensatory” damages are recoverable and consequential damages are excluded
  - Actual, compensatory damages deemed to include “costs incurred in directly contributing to the repair of defective equipment”
  - Repair study, lost profits, idle labor, schedule delay and project disruption costs, and loss of use of related goods deemed consequential damages, not recoverable
  - Sounds like direct and incidental damages, but . . .
What Are “Actual, Compensatory” Damages? (cont’d)

  - Clause: “actual, compensatory damages” recoverable, but “special, indirect, incidental and consequential” damages excluded
  - Cost of repair deemed compensatory damages
  - Cost of engineering and consulting fees to analyze repair deemed compensatory (different from *Cooper*, supra)
  - Claims for lost profits and loss of use deemed consequential damages, not recoverable
What Are “Incidental And Consequential” Damages?

  
  - Clause: allows “direct damages” and excludes “consequential damages, and loss or expense arising in connection with the use or inability to use the product . . . .”
  
  - Plaintiff recovers the difference between the value of the goods as warranted versus the goods as delivered as direct damages
  
  - Plaintiff also recovers inspecting, shipping, handling and storing the defective units (incidentals, not excluded)
  
  - Lost profits excluded from recovery as “consequential damages”
What Are “Incidental And Consequential” Damages? (cont’d)

- Nyquist v. Randall, 819 F.2d 1014 (11th Cir. 1987) (Florida Law): Defendant breached contract to supply conforming cattle
  - Consequential damages defined as damages:
    - “resulting from general or particular needs” of the purchaser
    - Not recoverable unless “the seller at the time of contracting had reason to know” of the possibility that they would occur, and
    - Not recoverable unless they “could not reasonably be prevented by cover or otherwise”
  - No contractual clause prohibiting consequential damages
  - Lost profits awarded as consequential damages since Plaintiff tried to prevent loss by renegotiating lease for cattle
Which Are Recoverable? (only “direct” damages under the contract)

- Cost to remove the components from satellites? **Maybe**
- Cost to ship components to Failure, Inc. for investigation? **Maybe**
- Cost to investigate the failures? **Very Unlikely**
- Cost to repair or re-design the electric components? **Definitely**
- Component level testing? **Maybe**
- Cost to ship repaired components back to Satellites Are Us? **Maybe**
Which Are Recoverable?
(only “direct” damages under the contract) (cont’d)

- Cost expended by Satellites Are Us to re-test the satellites? **Probably Not**
- Potential damages payable to the commercial satellite customers caused by loss of revenue from delayed launch? **Definitely Not**
- Payment to Government customers if contracts are terminated by default; damages for delayed launch? **Definitely Not**
Satellites Are Us Lessons Learned

1) Tailor your limitation of liability provision to the types of damages that are likely to occur
   a) Satellites Are Us should have sought indemnification for all foreseeable costs and damages that could result from failures

2) Define the types of damages: “the parties agree that the costs to ship any defective electronic equipment falls within the category of incidental damages”

3) Ensure your limitation of liability provision creates certainty. “Contractor’s total liability under this contract…”
   a) shall not exceed the price set forth in the contract…” or
   b) “shall be capped be $__ per day, for a maximum for __ days”

4) Periodic legal research on the best choice of law
Presenters

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