PCI Supply Chain Symposium: Mandatory FAR Flow-Down Clauses and Best Practices

(updated through January 5, 2023)

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Goals

- Provide up to date compliance information for performance of US Government contracts (prime & sub)
- Provide a framework for evaluating flow-down requirements in different contracting circumstances
  - Enable prime contractors to identify contract requirements that must or should be in subcontracts
  - Equip subcontractors with information to effectively negotiate
- Identify new, substantive flow-down issues as of 01/05/23
- Not a comprehensive list of all flow-downs

Overview

- Key Concepts And Definitions
  - From the Federal Acquisition Regulation (FAR)
- Mandatory Flow-downs
  - Commercial product and service subcontracts
  - Non-commercial product subcontracts
  - Non-commercial service subcontracts
- Recommended FAR Flow-downs / “Gap Filling”
- Best Practices
- Updated 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 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?

- United States Government ("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, price and risk for performing a subcontract

Mandatory vs. Non-Mandatory Flow-downs

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
- 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 contact, 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
  - *UPMC Braddock, et al. v. Harris*, 934 F. Supp. 2d 238, 259 (D.D.C. 2013), vacated as most on other grounds, appeal dismissed *sub nom. UPMC Braddock v. Perez*, 584 F. Appx. 1 (D.C. Cir. 2014)
    - 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 product/service
- Non-commercial subcontracts

Prime and subcontract payment terms

- Fixed price
- Cost reimbursement
- Time and materials

Contract value

- OFCCP Socio-economic clauses: $10,000
- Simplified Acquisition Threshold: $250,000 and $7.5M for commercial items
- TINA Threshold: $2M

What Is A Commercial Product? FAR 2.101

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

What Is A Commercial Service? FAR 2.101

- Installation services, maintenance services, repair services, training services, and other services if–
  - Such services are procured for support of a commercial product; and
  - The source of such services provides similar services contemporaneously to the general public
- Services of a type offered and sold competitively in substantial quantities in the commercial marketplace based on established catalog or market prices

January 2023 Mandatory FAR Flow-Downs For Commercial Product/Service Subcontracts

	Twenty "Must Haves" FAR 52.244-6(c)(1)	
1	FAR 52.203-13	Code of Business Ethics and Conduct
2	FAR 52.203-15	Whistleblower Protections Under the American Recovery and Reinvestment Act
3	FAR 52.203-19	Prohibition on Requiring Certain Internal Confidentiality Agreements or Statements
4	FAR 52.204-21	Basic Safeguarding of Covered Contractor Information Systems
5	FAR 52.204-23	Prohibition on Contracting for Hardware, Software, and Services Developed or Provided by Kaspersky Lab and Other Covered Entities
6	FAR 52.204-25	Prohibition on Contracting for Certain Telecommunications and Video Surveillance Services or Equipment
7	***FAR 52.219-8***	***Utilization of Small Business Concerns***
8	FAR 52.222-21	Prohibition of Segregated Facilities
9	FAR 52.222-26	Equal Opportunity
10	FAR 52.222-35	Equal Opportunity for Veterans
11	FAR 52.222-36	Equal Opportunity for Workers with Disabilities
12	FAR 52.222-37	Employment Reports on Veterans
13	FAR 52.222-40	Notification of Employee Rights Under the National Labor Relations Act
14	FAR 52.222-50	Combating Trafficking in Persons
15	***FAR 52.222-55***	***Minimum Wages Under Executive Order 14026***
16	FAR 52.222-62	Paid Sick Leave Under Executive Order 13706
17	FAR 52.224-3	Privacy Training
18	FAR 52.225-26	Contractors Performing Private Security Functions Outside the U.S.
19	FAR 52.232-40	Providing Accelerated Payments to Small Business Subcontractors
20	FAR 52.247-64	Preference for Privately Owned U.S.-Flag Commercial Vessels

January 2023 Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

1. Contractor Code of Business Ethics and Conduct, FAR 52.203-13 (Nov. 2021)
   - 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 *$6,000,000* with performance period of 120+ days
2. Whistleblower Protections Under the American Recovery and Reinvestment Act, FAR 52.203-15 (Jun. 2010)
   - Post notice of employee rights to whistleblower protection and the remedies that apply in the case of retaliation

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

3. Prohibition on Requiring Certain Internal Confidentiality Agreements or Statements, FAR 52.203-19 (Jan. 2017)
   - Internal confidentiality agreements or NDAs cannot prohibit reporting waste, fraud, or abuse related to the performance of a USG contract
   - Funding authorization pulled if USG determines Contractor is not in compliance with this clause

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

4. Basic Safeguarding of Covered Contractor Information Systems, FAR 52.204-21 (Nov. 2021)

- Apply basic safeguarding requirements and procedures to protect covered contractor information systems (CIS), including:
  - limit access to CIS based on specific criteria and authenticate identities of those granted access
  - control information posted on publicly accessible CIS
  - separate publicly accessible CIS
  - sanitize or destroy system media before disposal or release for reuse
  - monitor, control and protect communications
  - identify, report, and correct CIS flaws in a timely manner
  - protect against malicious code

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

5. Prohibition on Contracting for Hardware, Software, and Services Developed or Provided by Kaspersky Lab and Other Covered Entities, FAR 52.204-23 (Nov. 2021)
   - General prohibition on the sale of Kaspersky Lab products to the USG and their use in developing data in performance of a contract
     - Applies to all subcontracts

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

6. Prohibition on Contracting for Certain Telecommunications and Video Surveillance Services or Equipment, FAR 52.204-25 (Nov. 2021)
   - General prohibition on providing to the Government any equipment, system or service where telecommunications equipment manufactured by certain companies is a substantial or essential component
     - Contractors must insert the substance of this clause in all subcontracts.

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

7. Utilization of Small Business Concerns, FAR 52.219-8 (Oct. 2022)
   - Agree to carry out USG's policy of encouraging participation of small business concerns in performing contracts
   - Threshold: $750,000 ($1.5 million for construction of any public facility)
8. 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 Subcontracts *(Cont.)*

9. Equal Opportunity, FAR 52.222-26 (Sep. 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
   - Trigger threshold: $10,000
10. Equal Opportunity for Veterans, FAR 52.222-35 (Jun. 2020)
   - Trigger threshold: $150,000
11. Equal Opportunity for Workers with Disabilities, FAR 52.222-36 (Jun. 2020)
   - Prohibits discrimination on the basis of disability and requires affirmative action to employ and advance qualified individuals with disabilities
   - Trigger threshold: $15,000

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

12. Employment Reports on Veterans, FAR 52.222-37 (Jun. 2020)
    - Requires USG contractors and subcontractors to report annually, no later than September 30, 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
13. 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 Subcontracts *(Cont.)*

14. Combat Trafficking in Persons, FAR 52.222-50 (Nov. 2021)
    - Updated in 2015 to expand the definition of trafficking and include requirement for notification to USG of violations of clause
    - Compliance program for contracts and subcontracts for supplies, other than COTS, acquired outside the United States, or services performed outside the United States
      - employee training
      - posting of a written compliance plan
      - process for employees to anonymously report violations
      - annual compliance certifications
    - Trigger threshold: $550,000

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

15. Minimum Wages Under Executive Order 14026, FAR 52.222-55 (Nov. 2020)
    - Requires contractors and subcontractors to pay workers, while performing work on a USG contract in the United States, a minimum hourly wage rate annually adjusted to meet the Secretary of Labor's minimum determination
      - Currently $15.00 per hour effective Jan. 30, 2022
        - Will be further adjusted for inflation ***annually***
      - $10.50 per hour for tipped workers as of Jan. 30, 2022
        - The tip credit is to be phased out completely by Jan. 1, 2024, at which point tipped employees will be subject to the same minimum hourly rate as everyone else.
    - Applies to all contracts – no threshold

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

16. Paid Sick Leave Under Executive Order 13706, FAR 52.222-62 (Jan. 2017)
    - Contractors must provide sick leave and allow not less than one 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

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

17. Privacy Training, FAR 52.224-3 (Jan. 2017)
    - Requires contractors to conduct privacy training to employees who can access systems of records containing personally identifiable information (PII) to ensure safeguarding
    - Contractor must keep documentation of training completion and may be asked by the Contracting Officer to provide such information

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

18. Contractors Performing Private Security Functions Outside the U.S., FAR 52.225-26 (Oct. 2016)
    - Requires training, human resource vetting, arms control, and reporting of situations where firearms are used
    - Contractors required to cooperate with USG investigations

Mandatory Flow-Downs For Commercial Subcontracts *(Cont.)*

19. Providing Accelerated Payments to Small Business Subcontractors, FAR 52.232-40 (Nov. 2021)
    - Applies if payments are accelerated by USG
    - The acceleration of payments under this clause does not provide any new rights under the Prompt Payment Act
20. Preference for Privately Owned U.S.-Flag Commercial Vessels, FAR 52.247-64 (Nov. 2021)
    - Requires U.S. flagged commercial vessel for shipment of more than 50% gross tonnage whenever transporting by ocean vessels

January 2023 Mandatory Flow-Downs For Non-Commercial Product Subcontracts

- Same Twenty Mandatory Flow-Downs for Commercial Subcontracts, PLUS (at least) six more (depending on the type of contract), PLUS the COVID-19 clause:
  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

2023 Mandatory Flow-Downs For Non-Commercial Product Subcontracts *(Cont.)*

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, $2M
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

FAR 52.223-99, Ensuring Adequate COVID-19 Safety Protocols for Federal Contractors (Oct 2021)

- Requires compliance with the Safer Federal Workforce Task Force's Guidance for Federal Contractors and Subcontractors
  - Mandates vaccinations for all employees that perform services in connection with a federal contract
  - Applies to back-office support and remote support within the U.S.
  - Mandatory flow-down above simplified acquisition threshold
- Not mandatory – but "strongly encouraged" – for contracts and subcontracts below the simplified acquisition threshold or those solely for the provision of products
- October 19, 2022, update from the Safer Federal Workforce:
  - Despite the lifting of the nationwide bar to enforcement on October 18, 2022, at this time agencies should not: (1) take any steps to require covered contractors and subcontractors to come into compliance with previously issued Task Force guidance; or (2) enforce any contract clauses implementing Executive Order 14042.

January 2023 Mandatory Flow-Downs For Non-Commercial Service Subcontracts Other Than Construction

- Same Twenty Mandatory Flow-Downs for Commercial Subcontracts, PLUS six applicable to non-commercial Subcontracts, PLUS the COVID-19 clause, 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

2023 Mandatory Flow-Downs for Non-Commercial Service Subcontracts Other Than Construction *(Cont.)*

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, FAR 52.203-16
   - Procedures to screen employees that will perform acquisition functions closely associated with inherently governmental functions on service contracts

Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down

- Organizational and Consultant Conflicts of Interest (tailor from FAR 9.5
  - Contractors may be disqualified from acquisitions for organizational conflicts of interest ("OCI") based on unequal access to information, biased ground rules, or impaired objectivity

Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down *(Cont.)*

- Reporting Executive Compensation and First-Tier Subcontract Awards, FAR 52.204-10
  - Requires prime contractors to report income of top five compensated executives for first-tier subcontract awards of $30,000 or more and,
  - If in the preceding year, the subcontractor (i) received more than 80% of its revenue from federal sources and (ii) received more than $25,000,000 from Federal contracts (and subcontracts), loans, grants (and subgrants), cooperative agreements, and other forms of Federal financial assistance
- Termination for Convenience, FAR 52.249-2 for FFP
  - 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.)*

- Changes, FAR 52.243-1 for FFP
  - Allows prime contractor to make changes to subcontract requirements should the Government make changes to the prime's requirements
- Protest After Award, FAR 52.233-3
  - Allows prime contractor to issue stop work order to the subcontractor

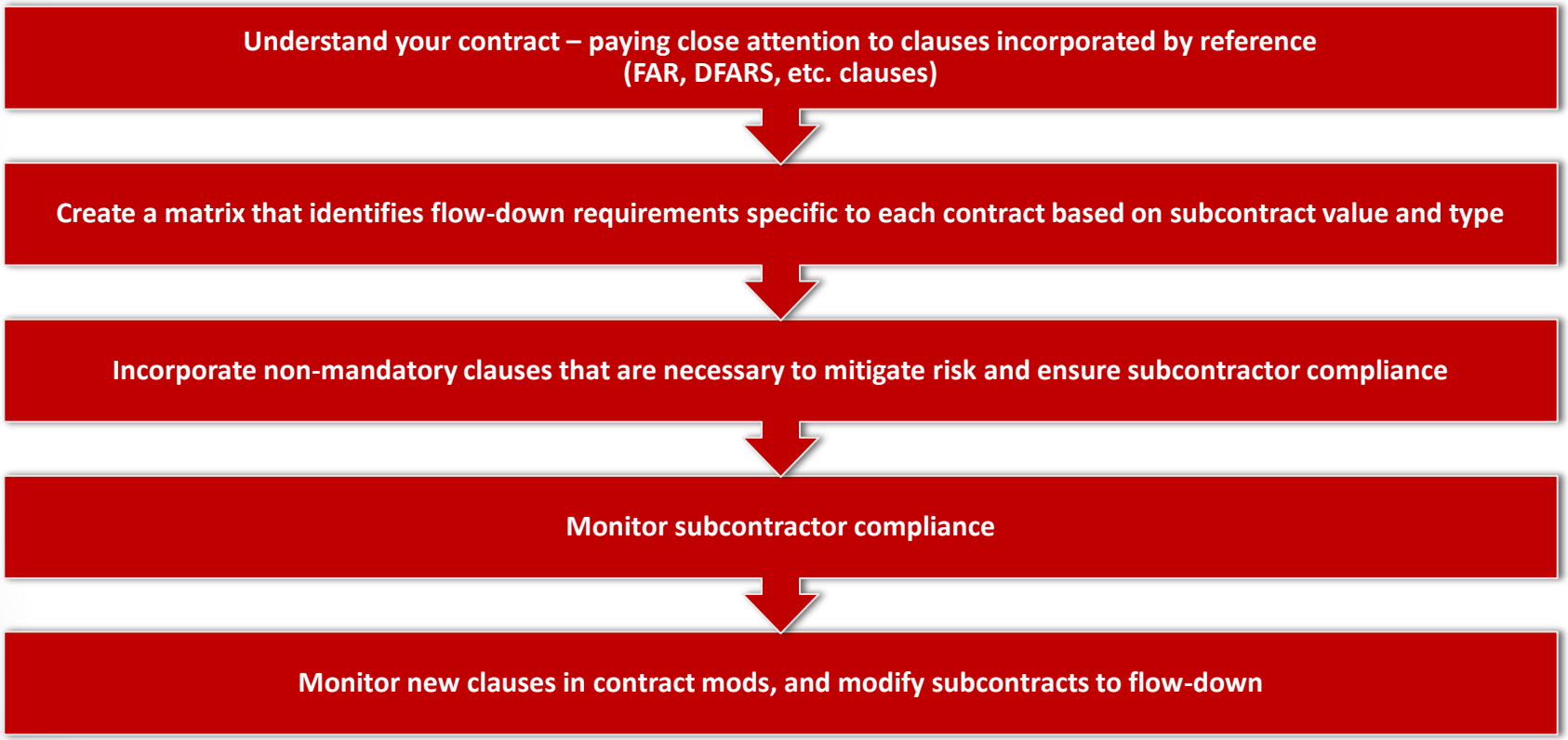
Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down *(Cont.)*

- Disputes Clause, FAR 52.233-1
  - 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

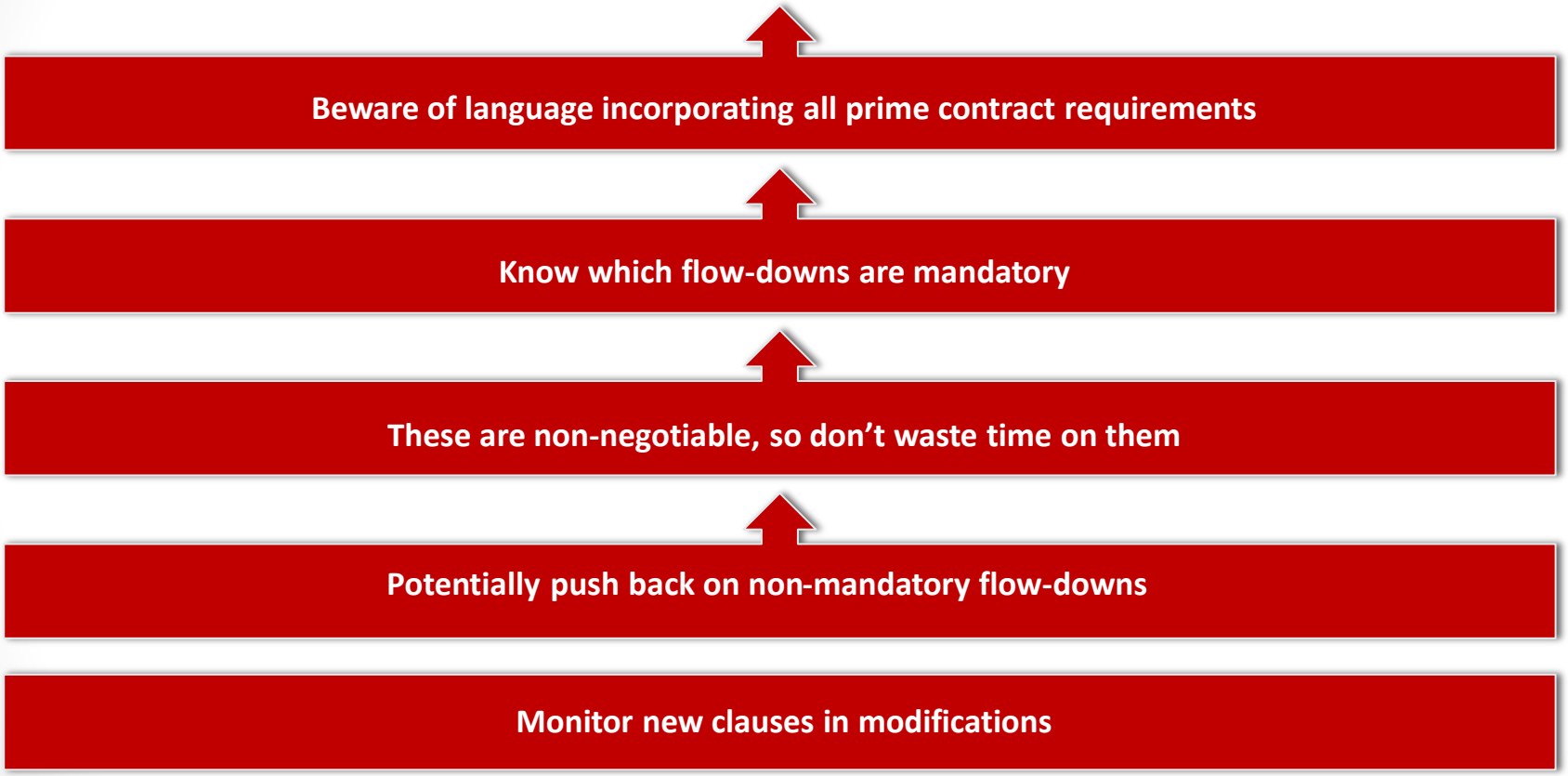
Non-Mandatory Clauses Prime Contractors Should Consider Flowing-Down *(Cont.)*

- Data Rights, FAR 52.227-14
  - Primes required to obtain from subcontractors "all data and rights therein necessary to fulfill the . . . Contract"
  - Especially important in research and development contracts

Flow-Down Best Practices – Prime Contractor



Flow-Down Best Practices – Subcontractor



Subject	UCC	FAR	FAR Part 12: Commercial Product/Service
Warranties	• 2-313: Express Warranties • 2-314: Implied Warranty of Merchantability • 2-315: Implied Warranty (Fitness for Particular Purpose)	• 46.706: All warranties must be express • 52.246-17 and -18: Contain warranties for simple and complex items	• 52.212-4(o): Warrants Merchantability and Fitness • Accommodates Commercial Tendencies • Negotiable
Title Passage and Risk of Loss	• 2-401: Title passes when seller completes delivery • 2-509: Risk of loss passes on delivery	• Driven by payment types: progress v. performance-based • 46.505(a): Title passes on formal acceptance • 46.505(b): Risk of loss upon delivery if FOB origin; upon acceptance if FOB destination • Government Property	• 52.212-4(j) and (n): Both title and risk are negotiable • Fallback position—FAR assumptions
Audit Rights	• No coverage	• 52.215-2: Audit and Records, Negotiation: • Until 3 years from final payment • Proposal, pricing, and negotiation and performance records • Additional "audit" rights under the inspections clause	• 52.212-5(d): If competitive, exceeds simplified threshold and excludes 52.215-2: • Until 3 years from final payment • Access to "directly pertinent" records involving transaction related to the contract
Indemnification/ Limitation of Liability	• Allocation of risks entirely negotiable • Avoid "betting the company"	• Subpart 46.8: Contractor relieved of liability if loss or damage occurs after acceptance	• No liability for consequential damages

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.)*

- 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 USG customers if satellite contracts are terminated for default; or damages for delayed launch

What Does The Satellites Are Us Subcontract With Failure, Inc. Provide?

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
- *Hospital Computer System, Inc. v. Staten Island Hosp*., 788 F. Supp. 1351 (D. N.J. 1992): Cost to repair or replace is the proper remedy for a seller's delivery of sub-standard computer goods

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.)*

- *Canal Elec. v. Westinghouse Elec.*, 756 F. Supp. 620 (D. Mass. 1990): Seller breached contract to supply conforming rotor blades
  - 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?

- *Consol. Data Terminals v. Applied Digital Data Systems*, 708 F.2d 385 (9th Cir. 1983) (New York Law): Warranty action by computer distributor against manufacturer
  - 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.)*

- *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

Side issue: Are the limitations enforceable?

- *In re Chateaugay Corp.*, 162 B.R. 949 (Bankr. S.D.N.Y. 1994) (applying NY law): Plaintiff sought to recover withheld purchase price for defective goods replaced over one year after delivery date
  - Battle of Forms: PO sent, Order Acknowledgement disclaimed liability for late delivery (an incidental damage) and consequential damages
    - Between merchants, Acknowledgement becomes part of contract unless:
      1. PO limited acceptance to its own terms;
      2. Buyer rejects terms w/n reasonable time; or
      3. terms "materially alter" the contract
  - Whether terms "materially alter" may depend on if there is "surprise or hardship" – Look to course of dealings and whether limitation is unconscionable or fails of its essential purpose
    - Delay of replacement for over one year may fail essential purpose

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.)*

- 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. Beware "Battle of Forms" issues: always condition Purchase Orders
5. Periodic legal research on the best choice of law

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