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Subcontractor Remedies: Prevention of Procurement Problems

By Morton J. Gold

INTRODUCTION

Subcontractor problems are a bread and butter item for the few attorneys representing organizations doing business with the United States Government through a prime contractor. However, for those attorneys unfamiliar with subcontractor problems, a few paragraphs of background information might be desirable.

Contracting is the basic method used by the United States Government to procure needed supplies and services from private businesses. As a sovereign the Government has the inherent power to enter into contracts and to seek the enforcement thereof, even though such action may not be expressly authorized by the Constitution or statute. Normally, the law which determines the validity of Government contracts is similar to that which governs private contracts. As the Government is an abstract entity, it can act only through its agents. Specific executive agencies authorize contracting officers as agents to enter into and administer contracts and private parties are charged with notice of all limitations upon a contracting officer's actual authority.

The term "prime contractor" in Government procurement refers to a person, partnership or corporation that has a contractual obligation to perform work or furnish materials in fulfillment of a particular Government contract. A subcontractor is defined similarly except that he is not a party to the particular contract with the Government. The subcontractor may be dealing with a prime contractor who holds the Government contract or

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he may be dealing with another subcontractor who is on a higher tier. Although the subcontractor, unlike the prime contractor, is not in privity of contract with the Government, the Government's direction and control is felt by the subcontractor in many ways. The Buy American Act, the Copeland Act, Davis-Bacon Act, Renegotiation Act, and Vinson-Trammel Act all specifically refer and apply to the subcontractor. In addition, certain provisions of the Armed Services Procurement Regulations place requirements upon the prime contractor having a direct bearing upon the subcontractor.

The terms "subcontractor" and "prime contractor" are not indicative of relative size of the contractors. Subcontractors range in size from the largest corporations to the smallest. It is not unusual for a corporation to be a prime contractor on one or more Government contracts and at the same time be a subcontractor as to other Government contracts.

The directives being used for military Government procurement are the Armed Services Procurement Regulations, which are published by the Department of Defense and are a loose-leaf collection of regulations divided into seventeen sections and five appendixes. These Regulations are modified by Defense Procurement Circulars plus Procurement Instructions and Circulars promulgated by each of the Armed Forces.

In the normal progress of a contract toward completion, a "dispute" begins when a disagreement arises between the contractor and the Contracting Officer. The preferred method of settling the dispute is by agreement between the parties. If they fail to agree, the Contracting Officer is authorized under the terms of the "Disputes" clause to decide the dispute ex parte. If the contractor is dissatisfied with the decision of the Contracting Officer, he must file a notice of appeal within 30 days from the date on which he received the decision. Normally the appeal is to the Secretary of the military department concerned, whose duly authorized representative for this purpose is the Armed Services Board of Contract Appeals. The ASBCA was created in May 1949 by a joint directive of the Secretaries of the Army, Navy and Air Force. Its general delegation of authority in connection with contract appeals is found in the Armed Services Procurement Regulations. However, as will be seen later in this
article, Subcontractors who have “disputes” with their prime contractors and disagreements with the Government have certain difficulties in coming within the jurisdictional focus of the ASBCA. These difficulties are also present when the subcontractor attempts to find its remedy on the judicial scene. It is interesting to note that one of the most troublesome areas has been with respect to allowability of costs in cost-reimbursable contracts.

Remedies

With each passing day prime contractors and subcontractors are becoming increasingly involved in costly and undesirable problem areas with regard to Government procurements. Many of these expensive difficulties might have been avoided through advanced planning or research by the subcontractor. Just as there are programs of preventive maintenance, preventive medicine and preventive law, so too should there be a positive program on the part of the subcontractors directed towards the prevention of procurement problems. This program should emphasize subcontractor remedies under those rules established by the United States Government, the Courts, the Armed Services Board of Contract Appeals and the use of common sense.

Frequently, subcontractors under economic pressure for business will not stop to properly check the financial status and integrity of a prime contractor. In many cases, the subcontractor will execute a contract solely on the basis of the prime contractor’s having been selected as a Government contractor. This is an extremely risky business practice. The sub should first investigate the prime as thoroughly as possible to ascertain if he is responsible. For example, if he does not check the credit rating of the prime, he may be bargaining for some expensive litigation, because even if he has reason to be confident of certain payment, the delivery date of the money may be postponed. Some primes will delay payment to their subs and material suppliers until after collection of their full progress payments from the Government; hoping to finance the job with either the Government’s or the subcontractor’s money. Normally, subcontractors know the reputation of a prime, located in their area, for prompt payment of his subs and vendors, however caution should be exercised when dealing with an unknown prime contractor.
Subcontractors should determine whether the work to be performed is protected by a payment bond which will guarantee payment for labor and materials. Examination of the government issued invitation for bid will usually disclose payment bond requirements. If it appears at any time that the prime lacks financial responsibility, the sub should immediately consult an attorney. However, as the prime is a customer of the sub, the latter must consider the fact that his consultation with an attorney may effect his future relationship with his customer. Hence, he should exercise due caution and common sense in attempting to collect for his labor and materials.

The best method of settling any dispute is through negotiation with the hope that the Government will bear the cost of such settlement. If the Government terminates a prime contract for its own convenience and a subcontractor-primecontractor dispute arises as a result of such termination, the Government may pay the settlement cost if the settlement is reasonable in amount, negotiated in good faith, and is allocable to the terminated portion of the contract.¹

Another method of settling a dispute is to submit the problem to arbitration, provided that there is appropriate authority for arbitration expressed in a subcontractual provision or some appropriate law.²

Sometimes disputes between subs and primes cannot be settled by negotiation or arbitration, but must be litigated. The resulting judgment is binding upon the parties subject only to normal appellate action. The standard termination clauses allow the Government to reimburse the prime on the basis of such judgment, provided: (a) the contractor has made reasonable efforts to include in the subcontract the termination clause prescribed in ASPR 8-706 or a similar clause excluding payment of anticipatory profits or consequential damages; (b) the provisions of the subcontract were fair and reasonable and do not unreasonably increase the common law rights of the subcontractor; (c) the prime made reasonable effort to settle the claim of the sub; (d) the prime gave prompt notice to the contracting officer of the

¹ ASPR 8-208.3 (1963).
² ASPR 8-208.5(b) (1963).
claim and proceedings; and (e) the prime diligently defended the suit and cooperated with the Government in the matter.\(^3\)

The question of whether or not a subcontractor comes within the purview of the disputes clause is questionable. This boilerplate provision is in most Government contracts and provides that any dispute concerning a question of fact which cannot be settled by agreement will be decided by the contracting officer with a right of appeal to the head of the particular department or agency. The decision of the head of the department or agency is final and conclusive unless upon review by a court it is found to be fraudulent or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith or is not supported by substantial evidence. Generally, the subcontractor has no right to submit a dispute to the contracting officer or to the head of a department or agency because there is a lack of “privity” of contract between the sub and the Government.

“Privity of contract” is defined for purposes of Government contracts, as the relationship of rights and duties that exist between immediate parties to a contract. Though a prime contractor has a contractual relationship with both the Government and its subcontractors, it cannot be said that the Government is in privity with the subcontractors. The Government can deal only with people with whom it is in privity.\(^4\) If this rule did not exist and the Government could deal directly with subcontractors for the settlement of their claims under prime contracts, the prime contractors, having the basic responsibility for the claims, would have no knowledge of the settlement action taken by the Government. Thus, it would be possible for the Government to reimburse the prime contractor for payment of a claim already paid; resulting in a variety of unfavorable situations. Also, the “no-privity”-rule allows the prime contractors to deal with subs without the restrictions that would be present if the Government were directly involved. In addition, there is a savings that accrues to the Government by not being required to administer the subcontracts nor being required to referee disputes between the subs and primes. Thus, this rule forces the prime contractor to manage his own contracts.

\(^3\) ASPR 8-208.5(a) (1968).
\(^4\) 23 Comp. Gen. 685 (1944).
The question of whether a subcontractor can file an appeal directly to the Armed-Services Board of Contract Appeals (ASBCA) has been the subject of controversy for years. The Board of Contract Appeals has been reluctant to take jurisdiction over such direct appeals unless the terms of the subcontract so provide. However, the Board has taken jurisdiction where the claim was brought by the prime contractor. Although the prime has a basic right to appeal on the subcontractor's behalf, the Government is not liable in such an appeal if the subcontract contains a clause relieving the prime of liability to the sub for Governmental activities. Even though there is no formal contract between the Government and the sub, circumstances, such as provisions in the subcontract or Government agreement to settle with the sub, may give rise to sufficient "privity" to enable the sub to directly appeal its claim to the ASBCA. The wording of the clause often times determines whether the ASBCA will take jurisdiction of an appeal filed directly by the sub. In the Richmond Steel Co., Inc. case, supra, the Board took jurisdiction while a contrary result was reached in Remler Co., Ltd.

An examination of the current regulations on this subject reveals a tendency to give subcontractors a greater right of appeal, but still fail to meet the desires of the contractors and their associations. Armed Services Procurement Regulations express the policy that a contracting officer should not consent to a subcontract which gives the sub a direct right to obtain a decision from the contracting officer or to appeal to the ASBCA, and in addition, that contracting officers should not participate in disputes between primes and subs. However, subcontractors, particularly under cost-reimbursement type prime contracts, are acceptable if they allow subs (who are affected by disputes arising under the prime contract) to indirectly appeal to the ASBCA by either (a) appealing in the prime's name, or (b) having the prime prosecute the appeal on the sub's behalf. But the subcon-

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8 ASBCA 5295 (1960).
9 ASPR 3-903.5 (1964).
tract may not attempt to obligate the contracting officer or the Board to decide questions which arise outside the disputes clause of the prime contract nor may it obligate the contracting officer to notify or deal directly with the sub. The prime and the sub may agree to arbitrate their disputes, but subcontracts which attempt to make the results and costs of such arbitration binding on the contracting officer may not be approved; however arbitration results are subject to an independent review under the prime contract.\textsuperscript{10}

The wording of the “Disputes” clause in the subcontract is extremely important because it can affect the legal remedies of the sub against the prime. For example, in the case of \textit{Fanderlik-Locke Co. v. United States}, the court held that when construed in their entirety, the effect of the prime contract and subcontract was to integrate the Disputes clause of the prime into the subcontract and make it applicable to disputes of fact between the contractor and subcontractor.\textsuperscript{11} Since the clause has application to disputes between the contractor and the subcontractor over questions of fact, the exhaustion of the administrative remedy provided in the clause is a prerequisite to the right to maintain a court action and final judgment.

Since promulgation of the former ASPR 3-903.5, approximately two years ago, there has been no case or series of cases indicating that the door has been opened to more appeals by subs. Thus, the situation with regard to the Armed Services appears to be in a status quo. However, there are several other agencies which do allow direct appeals by a subcontractor to the contracting officer (i.e., the Atomic Energy Commission and the National Science Foundation).

There are times when a subcontractor feels that he has no avenue of relief except to bring an action against the Government in either the Court of Claims or the U.S. District Court. Most of these cases have been dismissed on two grounds: (1) the doctrine of sovereign immunity, and (2) the lack of contractual relationship between the Government and the subcontractor. As to the doctrine of sovereign immunity, it should be noted that the United States cannot be made a party defendant in any suit

\textsuperscript{10} \textit{ASPR 3-903.5(c)} (1964).
\textsuperscript{11} 285 F.2d 939 (1960).
without its consent, and where consent is lacking the suit must be dismissed. The Tucker Act expresses the consent of the United States to be sued where the suit is based "upon any expressed or implied contract with the United States." In determining whether there is such a contractual relationship between the subcontractor and the Government, the main issue is to determine whether the court has jurisdiction to hear the case. That is, whether there exists an expressed or implied contract between the plaintiff and the United States. In this regard many cases have indicated that there is no contractual relationship even where there is an expectation of payment. The fact that the government has obligated itself to reimburse the prime contractor for its costs under a cost type contract does not create a contract between the Government and subcontractor. In addition, just because the government derives a benefit from the subcontractor's performance or approves the subcontract does not create an implied or expressed contract with the United States. Furthermore, the fact that the prime contract provides that subcontracts must receive prior approval of the contracting officer and stipulates that certain clauses must be inserted in all subcontracts will not in itself result in the necessary Government-Subcontractor relationship.

However, there are a few exceptions to these rules. A subcontractor may file a suit against the Government directly and possibly recover when the Government makes the prime contractor its agent for placing subcontracts. Under these circumstances, the question arises as to whether a contract between the parties referred to as prime and subcontractor is really a subcontract. For our purposes, it is sufficient to say that there is an implied contract between the Government and the subcontractor; hence, the acts of the agent within the scope of his authority, are legally the acts of the principal. In addition, it has been held that there was an implied contract between the subcontractor

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and the Government where the latter, upon default of a prime, took the property belonging to the subcontractor at the construction site, knowing that the property belonged to the subcontractor. In that particular case the Government wanted the property and advised the sub that just compensation would be forthcoming. One theory of law which allows this type of action rests on the proposition that the Government acted outside the scope of the prime contract and not under the subcontract, such action creating the implied contract between the sub and the United States. Another exception to the general rule is that of "unjust enrichment." In the case of Armstrong v. United States the Government took property without just compensation when, pursuant to the prime contract, it destroyed the value of subcontract liens by requiring a defaulting prime contractor to transfer title of all contract property to the United States. Thus, it appears that there must be very unusual circumstances before a subcontractor can obtain payment directly from the Government by means of a law suit.

As to the situation where a prime contractor brings an action against the Government on behalf of the subcontractor, it must be noted that for such action to be permitted the prime must be able to prove that he suffered actual damages by the Government's breach of contract. It is not enough that such a breach caused the subcontractor actual damages.

In addition to the above methods of recovery, Public Law 85-804 also affords a remedy. This act provides that departments or agencies having national defense functions may extend extraordinary contractual relief to contractors. Generally speaking, Public Law 85-804 is the basis for action in three areas: (1) correction of mistakes; (2) formalization of informal commitments; and (3) amendments without consideration. In order to take advantage of the legislation, requests for relief should be filed with the contracting officer. Normally, a subcontractor's request filed directly will not be considered, although a prime contractor may file for relief on behalf of a subcontractor. A

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20 Supra, note 6.
subcontractor may have its request considered directly only if it seeks an amendment without consideration because of a loss under a defense contract which impairs its production ability and it is found to be essential to the national defense.\textsuperscript{22} Contracting officers may not approve or deny requests for contractual adjustment under the authority of Public Law 85-804 as such authority is vested in certain higher command positions.

There is a growing school of thought outside the Government that the Armed Services Procurement Regulations should be revised to authorize prime contractors to include in subcontracts a special "Disputes" provision affording subcontractors direct access to contracting officers with right of appeal to the Armed Services Board of Contract Appeals. At the present time, such revision is unacceptable for several reasons: (1) because of the administrative burdens that would be imposed upon the contracting officers and the ASBCA; (2) many issues would be irrelevant to Government interests; and (3) such appeals would cut across the carefully established lines of contract authority and responsibility, under which the Government knows who is responsible for performance and who must be paid, and under which it is entitled to and presumably pays for the prime's management capability and responsibility, including reviewing and settling subcontractor disputes.

Therefore, it is obvious that subcontractor remedies are rather limited when seeking relief from the Federal Government. Thus, in conclusion it is again emphasized with regard to the prevention of procurement problems, the more information a subcontractor can obtain in advance concerning his prime contractor, the prime contract, and his remedies, the better will be his chances of avoiding costly problems. In addition, this will greatly improve the Government-Contractor relationship in all aspects of Government Procurement.

\textsuperscript{22} ASPR 17-204.2(a) (1963).