

Isn't a Sale to the U.S. Government Just Another Commercial Sale?

by
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In the 1990s, in search of increased efficiency and competition, Congress elected to incorporate free-market principles into the Federal Acquisition Regulation (FAR). These revisions encouraged both the use and acquisition of commercial items¹ by simplifying the government's regulations and drawing them closer to commercial contracting practices.² Specifically, FAR Part 12, "Acquisition of Commercial Items," and the corresponding definitions of FAR Part 2 were rewritten to exempt commercial item vendors from many burdensome regulatory provisions.

However, free markets and government procurement practices are fitful colleagues, and both Congress and the regulators have been unable to resist meddling with commercial principles. As a result, the commercial items rules have become increasingly onerous since these revisions, with both Part 12 and the definitions in Part 2 having been amended in favor of more exacting and restrictive regulations.

Because of this, the commercial item regulations have become increasingly difficult to navigate. They have been freighted with regulatory provisions designed to pursue collateral policies that have little to do with free market efficiency.³ These competing goals produce a dichotomous tension that is difficult for market participants to interpret.

Most problematically, the current complexity of the rules limits contractors' ability to assess the risks and costs of commercial item procurements and thus reduces the overall amount of competition for contract awards.⁴ This is plainly contrary to what Congress initially intended with the FAR revisions. Congress must now choose either to relinquish its original free market principles incorporated into the FAR or reinvigorate them.

Commercial Items Acquisition

Purpose and Structure: Exemptions to Government-Specific Requirements

Historically, commercial contractors have been forced to satisfy cumbersome regulations, such as the Cost Accounting Standards (CAS),⁵ the Truth in Negotiations Act (TINA),⁶ and the FAR Part 31 cost principles. Unfortunately, these regulations, theoretically

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designed to promote integrity and fair competition among contractors, tend to stifle the competition in actuality. Mandated compliance with these and a host of other government-specific requirements requires contractors to expend more on overhead and administration than their purely commercial counterparts, which causes contract cost inflation. The cost of implementing them and the risk of transgressing these complex rules results in industry reticence to engage in public procurement.⁷

For example, TINA's onerous terms generally require government contractors or subcontractors to submit and certify the currency, accuracy, and completeness of cost or pricing data for any nonexempt negotiated contract, subcontract, or modification expected to exceed \$650,000.⁸ What this effectively means is that, contrary to all commercial practices, the vendor must relinquish its most valuable bargaining advantage—i.e., holding its cost data closely—by disclosing all its cost or pricing data, including all facts that prudent buyers and sellers would reasonably expect to significantly affect price negotiations.⁹

The phrase "cost or pricing data" has been expansively interpreted by the courts and boards to include obvious cost data, such as vender quotations, to less obvious "facts," such as any data that supports make or buy decisions or any information bearing on management decisions that may have a significant effect on cost. Indeed, as a practical matter, the definition includes virtually any information that government auditors might imagine could have an effect on cost.¹⁰ In turn, contractors must have systems, procedures, and personnel in place to identify, gather, and disclose such data.

The CAS, which were intended to lower acquisition costs by creating a uniform system of accounting practices for government contractors, instead established complex criteria for measuring, assigning, and allocating the indirect costs of federal contracts in excess of \$650,000.¹¹ The CAS direct contractors on how to design their accounting systems and the manner in which they must account for certain types of costs.¹² These rules are difficult to understand, difficult to implement, and wholly different from the financial accounting systems used by purely commercial contractors. Developing and maintaining the special accounting and data collection systems required by CAS necessarily increases overhead costs and thus inherently threatens competition.¹³ Further, the CAS provide the government with broad audit rights to monitor and enforce contractor obligations.¹⁴

Historical Context

In 1991, the Department of Defense (DOD) in response to congressional directives set forth in the Defense Authorization Act for Fiscal Years 1990 and 1991,¹⁵ attempted to reduce barriers to commercial item acquisition in the Defense FAR Supplement (DFARS).¹⁶ These regulations created a new definition of *commercial item* which are items "regularly used in the course of normal business operations for other than government purposes."¹⁷ Following DOD's

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example, Congress enacted the Federal Acquisition Streamlining Act (FASA)¹⁸ in 1994, which established a preference for commercial item acquisition. FASA also established a unified definition of “commercial items” across the FAR and DFARS, and continued the DFARS policy of exempting items that fell under this definition from TINA and CAS requirements. Indeed, as a result, the most significant exemption from TINA now arose when selling a commercial item.

In various ways, the regulations implementing FASA also reduced the application of other unique regulatory standards and requirements, decreased barriers to entry, and encouraged commercial companies to offer their products to the government.¹⁹ The results of FASA included a decrease in overall procurement costs and the more efficient use of tax dollars.²⁰

The FAR Councils implemented FASA in 1995, and in so doing expanded the definition of “commercial items” when they added standalone services as “commercial items.”²¹ Similarly, commerciality was broadened when the definition was changed to maintain an item’s character as “commercial,” even if there were modifications to it “of a type” offered in the commercial world (rather than requiring the exact modification).²²

Congress adopted these regulatory changes and clarified the definition created by FASA with respect to the TINA exemption in the Clinger-Cohen Act of 1996, also known as the Federal Acquisition Reform Act of 1996 (FARA).²³ These changes, subsequently reflected in FAR Part 12, made it easier for commercial companies to compete in the previously inscrutable world of government contracts.

For example, FAR 12.301(b)(3) requires the insertion of clause 52.212-4, “Contract Terms and Conditions—Commercial Items,” which, among other things, states that the contractor “shall not be required to comply with the Cost Accounting Standards or contract cost principles” in a termination for convenience. FAR 12.302(c) prevents contracting officers from tailoring contract conditions or adding terms and conditions that are “inconsistent with customary commercial practice for the item being acquired,” unless a written waiver is granted by the agency.²⁴

Furthermore, FAR 12.504(b) limits the applicability of TINA regulations, which in turn generally exempts commercial items from TINA’s reach. Nonetheless, the contracting officer can obtain data “other than cost or pricing data” in certain circumstances for assessing the price reasonableness of a commercial item, subject to the limitation that the contracting officer must “to the maximum extent practicable, limit the scope of the request for information relating to commercial items to include only information that is in the form regularly maintained by the offeror as part of its commercial operations.”²⁵

Competing Theories: Oversight vs. Commercial Freedom

Viewing these changes objectively, there are clearly two sides to the commercial item

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topic. Free market enthusiasts argue that commercial item procurement offers the opportunity for the government to “take effective advantage of market-driven innovations and commercial economies of scale to obtain the best value from a globally competitive national industrial base.”²⁶ According to industry players, FASA has successfully reduced the application of special regulatory standards and requirements, decreased barriers to market entry for government contracts, and encouraged commercial companies to offer their products to the government.²⁷ Moreover, these decreased barriers provide “greater access to commercial technologies...[and] drive costs down.”²⁸ Put differently, simplified acquisition regulations allow contractors the flexibility they need to engage in competition for government contracts, which in turn results in more efficient procurement overall. From this perspective, procurement based on discretion rather than rigid rules constitutes a “significant step” in procurement, and is not prohibitive to securing best value.²⁹

The counter argument is that the administrative convenience of streamlined procedures actually limits competition and threatens recovery of best value because maximization of competition is not required.³⁰ On the other hand, the government’s decision to exempt commercial items from TINA and the CAS demonstrates some commitment to free market efficiencies and, necessarily, its recognition of the limits of statutory and regulatory protections.³¹ Although the government acts differently than private enterprise, and the courts have reinforced the distinction between government and private contracts,³² federal policy directs the government to provide commercially available products or services if they can be economically acquired during the procurement process.³³

In all events, both sides have pled their case to contracting officers because these officials possess a fair amount of discretion in choosing how to conduct a procurement. It is also difficult to hold government employees accountable for their actions or to prove that discretion has been abused; thus, the exemption of “commercial items” from TINA and CAS requirements remedies this potential imbalance through supplanting statutory protection with free market efficiency.³⁴ Nonetheless, government officials have lobbied to cut back more on commerciality, urging the need to maintain broader governmental policies. But these policies can override free market interests that commercial item exemptions were meant to foster.

To be sure, differences do exist between the government and private industry, and must be recognized, although with an even hand. Most importantly, the government is not driven by the profit motive or accountability to shareholders; rather, the government’s use of public funds obligates it to consider the public interest. Indeed, the need for transparency in the procurement process necessitates the need for the government to retain unique policies, solicitation provisions, required clauses, and other legislatively mandated requirements that prevent it from acting as a true commercial purchaser.³⁵ Thus, legislation mandates that the government provide equal opportunities for contractors to compete and the contractor to perform a contract despite directed changes or changed conditions that may require additional time or cost to the contractor.³⁶

Further, restraints prevent the government from completely adopting private industry
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commercial practices for several reasons, which include:

- The government and commercial buyers have different responsibilities;
- Legally mandated funding cycles limit the government's ability to consider assets and investment, similar to that of its private industry counterpart;
- Collateral policies inherent in federal procurement regulation³⁷; and
- The need for military-specific goods and services.³⁸

Because the federal procurement system furthers social policies, government officials must consider goals of congressional policy in addition to efficiency. On the efficiency side, one tangible benefit of commercial contracting includes a reduction in required socioeconomic programs inherent in public procurement law. For example, statutory contract clauses—which formerly required Buy America Act compliance regardless of purchase size, or the small business requirement for purchases under \$2,500—have been eliminated in commercial item acquisition.³⁹ However, “No matter how commercial, competitive, or cost-effective the federal acquisition system becomes, it ultimately will still be governed by public policies—policies that are driven not only by economic objectives, but also by social and political considerations.”⁴⁰

Therefore, the question becomes whether, notwithstanding political pressures and social policy, the differences between government and commercial practice should be reconciled. Lately, this question has been answered adversely to the free market.

Diminishing Use of Commercial Item Acquisition

As previously noted, with the passage of FASA and FARA, Congress accepted reduced levels of competition and transparency in order to exempt commercial items from various requirements, including having to submit certified cost and pricing data and to make the government more efficient.⁴¹ Ten years later, however, the pendulum has begun to swing the other direction. The following relates the direction of that swing.

Recommendations to Change the Definition of "Commercial Items"

Proposed FAR Changes

Recent recommendations threaten current commercial item exemptions by requiring a contracting officer to obtain “data other than certified cost or pricing data” when it is necessary for the government to determine whether it has received a fair and accurate price for the commercial item or service.⁴² Previously, although contracting officers were authorized to request “other than cost or pricing data” from commercial item contractors for purposes of determining price reasonableness,⁴³ there was no definition of what this “other” data was. This led the regulators to believe that contracting officers might therefore not be able to get information sufficient to evaluate price reasonableness. Accordingly, they proposed a definition of “other than cost or pricing data” that is intended to be the equivalent to cost or
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pricing data, but simply not certified:

“Data other than certified cost or pricing data means any data, including cost or pricing data *and judgmental information necessary* for the contracting officer to determine a fair and reasonable price or cost realism, *where certification is not required...*”⁴⁴

Although the proposed changes supposedly provide contracting officers and contractors with “clarification” regarding the contracting officer’s authority, they do far more than that. They essentially require all commercial contractors to have full-blown systems and processes to identify, collect, and disclose “other than cost or pricing data” that are equivalent to those required by noncommercial contractors who have to disclose “real” cost or pricing data. Therefore, the administrative burden and cost meant to be eliminated by the commercial item exemption from TINA would be fully reinstated. There would also be no difference between the burdens faced by commercial versus pure government contractors. These proposed changes will increase indirect costs associated with data collection and storage. Small- and medium-sized businesses will disproportionately feel the impact of the proposed requirements if they do not have the necessary architecture in place for collecting and disclosing cost or pricing data.⁴⁵

Statutory Changes

In a corollary enactment, Section 805 of the Defense Authorization Act for Fiscal Year 2008 applied similar requirements at DOD for commercial services “of a type” offered and sold competitively in substantial quantities in the commercial marketplace. That is, these commercial services may be exempt from TINA, but only if the contracting officer determines the offeror has submitted sufficient information to evaluate the reasonableness of the price for such services through price analysis.⁴⁶ This information reasonably includes the prices paid for the same or similar commercial services under comparable terms and conditions.

However, if the contracting officer finds this information insufficient to determine reasonableness of price, the contracting officer can require the contractor to submit “other relevant information regarding the basis for price or cost, including information on labor costs, material costs, and overhead rates.”⁴⁷ Given that these categories of costs comprise virtually all costs incurred by a contractor, this enactment means that commercial service providers can be exposed to the full administrative burden of TINA.⁴⁸

Recent FAR Changes

Congress also recently cut back on TINA’s commercial item exemptions for modifications. Modifications to commercial items that, under FAR 2.101, did not change the item from a “commercial” to a “noncommercial” item had been and remain exempt from TINA for civilian agencies. This has changed for “noncivilian agencies.” Specifically, cost and
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pricing data is now required under contracts with DOD, the National Aeronautics and Space Administration (NASA), or the U.S. Coast Guard for modifications to commercial items that cost more than \$500,000 or five percent of the total contract price, even if those modifications do not alter the commercial nature of the item.⁴⁹ Thus, commercial contractors are now responsible for ensuring the accuracy of cost and pricing data—as well as having the expense and risk associated with TINA compliance—for commercial items that are modified after the acquisition is complete, if the modifications exceed the thresholds.⁵⁰

Other Government Policies Inhibiting Private Participation in Government Contracts

The Civil False Claims Act

Apart from these express changes to the commercial item regulations, the government also embraces other departures from the private sector that drastically alter the risks found in the commercial marketplace, but which are not found in FAR Part 12.⁵¹ One of the most significant is the Civil False Claims Act (FCA). FCA liability arises when a corporation “knowingly presents, or causes to be presented, to [the government] a false or fraudulent claim for payment or approval” or “knowingly makes, uses, or causes to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the government.”⁵² The term “knowingly” requires either “actual knowledge” that the claim or statement is false, or to have acted in “deliberate ignorance” or “reckless disregard” of the falsity of the claim or statement.⁵³ The FCA thus permits the government to pursue civil actions for the knowing submission of inaccurate or incomplete information submitted in relation to government contracts.

For example, the FCA creates civil liability for a person who knowingly submits a false claim for payment by the government, uses a false statement to induce payment from the government, or conspires to defraud the government to pay a false claim.⁵⁴ Liability under the FCA increases the risk that a “firm’s failure to fulfill contractual agreements will be challenged as fraudulent and be subject to severe punishment”⁵⁵ if the contractor’s disclosure of information is inaccurate or incomplete.⁵⁶ The term “knowing conduct” includes actual knowledge as well as reckless disregard for the truth; thus, liability under the FCA accrues if a commercial contractor makes a representation without bothering to discern the truth or accuracy of information submitted for payment.⁵⁷

Regulatory and Statutory Restriction of Specialty Metals Acquisitions (Berry Amendment Requirements)

Another surprise and lurking risk for commercial contractors is the Berry Amendment.⁵⁸ Under these provisions, DOD is restricted from purchasing “specialty metals” — metals common in aerospace/defence manufacturing such as titanium or steel — unless the metals
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were melted in steel manufacturing facilities located within the United States.⁵⁹ Additionally, neither federal statute nor the Berry DFARS clause contains a commercial item exemption.⁶⁰ This is problematic for companies because typical commercial practice does not trace the origin of the melt. Because resellers and distributors cannot ensure compliance just by purchasing from U.S. manufacturers, they must, as a result, keep a dual inventory of metals used in manufacturing—one for DOD and one for all other customers. This is a significant burden for commercial contractors. To make matters worse, although DOD could not acquire specialty metals previously, it could acquire end items containing specialty metals. Thus, DOD could simply accept and decrement for nonconforming components. However, with the passage of the National Defense Act for Fiscal Year 2008,⁶¹ this changed—now the acceptance of end items that contain specialty metals is not allowed; the requirements now apply to commercial item procurements of end items.⁶²

Conclusion

In summary, as exemplified by the specialty metals requirements, commercial enterprises that are in business with, or are contemplating getting into business with, the U.S. government must recognize that federal commercial item acquisitions are not the same as commercial transactions in the private sector. The risks are greater, the costs are higher, and the returns are lower. Commercial contractors are already required to have systems in place to handle the unique requirements of government commercial contracts, and those systems and procedures will have to be significantly expanded if the regulations on other than cost or pricing data are finalized. Moreover, if they are finalized, fewer commercial companies will be inclined to do business with the government. That is certainly not what Congress intended when it encouraged commercial contracting. But it is equally certain that this will be the result if something is not done to rethink the policies behind commercial item contracting.

A fresh, objective look is essential because the government contract procurement system is not geared toward or entirely comfortable with commercial enterprise. Proof of this is the push toward increasing access to cost data—data never provided in the private sector. Thus, only the administration at a high level or Congress has the ability to reverse the trend away from commercial contracting as it was originally meant to be. If no one is willing to address this issue, then the inertia of increasing regulations will stifle commercial contracting, which would be a disservice to all.

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