

Close the Waste Loopholes: Reassessing Commercial Item Regulations in Federal Procurements

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CLOSE THE WASTE LOOPHOLES: REASSESSING COMMERCIAL ITEM REGULATIONS IN FEDERAL PROCUREMENTS

JIM R. MOYE*

ABSTRACT

Classifying an item as commercial reduces the government's ability to ask for information to determine whether prices are fair or reasonable, based on the assumption that these prices would be shaped by market forces. Since changes in procurement laws in the 1990s, contractors seem to want all items, as well as the entities that sell these items, to be listed as commercial. Contractors push for items to be labeled as commercial so they can avoid nearly all oversight and transparency requirements, which often results in the government buying blindly.¹

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¹ Scott H. Amey & Mandy Smithberger, *Thornberry Buying Industry Commercial-Item Policies*, THE PROJECT ON GOV'T OVERSIGHT (Apr. 28, 2015), <http://www.pogo.org/blog/2015/04/thornberry-buying-industry-commercial-Item-policies.html> [<http://perma.cc/86JU-SB8S>].

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INTRODUCTION

The Miksche Corporation (TMC) is one of the largest defense contractors in the world. Recently, the United States Department of Defense (DoD) awarded TMC a contract worth \$5 billion to build fifteen state-of-the-art fighter jets. The contract with DoD calls for TMC to deliver the first three fighter jets within twenty-four months of the contract award. As production of the fighter jet commences, TMC enters into negotiations with Sandayan Enterprises (SEnt) for production of an engine part. Although the engine part in question is small and weighs only fifteen pounds, the part is critical to the fighter jet and is the basis for the fighter jet's cutting edge technology. SEnt believes the part should be deemed commercial, having developed similar engine parts for commercial airliners, and argues the cost of the part is \$125,000 each. TMC disagrees and believes that the engine part is appropriate only on the fighter jet, which does not have value in the commercial market, and the cost of the part should be \$45,000 each. The parties negotiate back and forth over their positions for an extended period of time. Ultimately, the length of the negotiations adversely impacts TMC's production schedule, thus causing TMC to miss the first delivery dates for the fighter jet to the DoD. Meanwhile, the DoD has invested an additional \$250 million through infrastructure improvements, spare parts purchases, logistics and supply chain changes, and pilot training in anticipation of the on-time delivery of the fighter jets. The delivery delays will cost TMC an additional \$10 million dollars and the DoD \$12.5 million.

The hypothetical situation described above happens quite often in the global defense industry. Multi-billion dollar defense contracts with the DoD require strict compliance with the Federal Acquisition Regulation (FAR) and the Department of Defense FAR Supplement (DFARS).² A controversial group of regulations in the FAR and DFARS revolves around whether goods or services are considered commercial in nature.³ If they are considered

² See generally Federal Acquisition Regulations System, 48 C.F.R. § 1.104 (2014); 48 C.F.R. § 2.101; 48 C.F.R. § 201.104.

³ See Amey & Smithberger, *supra* note 1.

commercial, then the contractor is allowed to charge the government, or prime contractor, whatever the open commercial market price is for the goods or services. If the goods or services are not commercial, then the contractor is required to meet a number of additional requirements related to price justification, which will most assuredly result in an overall lower price to the United States government.⁴

Why should the average American care about whether the federal government is buying commercial goods or services? The short answer is money. In fiscal year 2014, the United States government spent over \$445 billion on federal contracting.⁵ Commerciality regulations, as they are known in federal government contracting, have a direct impact on the money spent with contractors and the prices ultimately paid for goods and services in support of the federal government. As shown in the hypothetical situation above, the price differential for a commercial versus a non-commercial good can be substantial.

A real world example of the consequences of improper utilization of the commerciality regulations was evident in the United States Air Force's procurement of 117 C-130J aircraft. The Department of Defense Office of the Inspector General (DoDIG) received allegations of poor contractor performance by Lockheed Martin, which included the C-130J.⁶ The C-130J performs intratheater airlift missions and is a platform for dropping troops and equipment

⁴ See generally 48 C.F.R. § 15.000–.403.

⁵ See Andy Medici, *Defense Department Spending Drops \$24 billion in 2014*, FED. TIMES (Mar. 26, 2015, 12:10 PM), <http://www.federaltimes.com/story/government/acquisition/policy/2015/03/25/contract-spending/70342582/> [http://perma.cc/76FX-G4ZH].

⁶ See generally U.S. DEP'T OF DEF. INSPECTOR GEN., D-2004-102, CONTRACTING FOR AND PERFORMANCE OF THE C-130J AIRCRAFT (July 23, 2004), <http://www.dodig.mil/Audit/reports/fy04/04-102.pdf> [http://perma.cc/86CW-EJJQ]. The report reads:

We performed this audit in response to allegations to the Defense Hotline concerning the Defense Contract Management Agency's oversight of Lockheed Martin's performance on the C-130, F-22, and C-5 aircraft. This is the third in a series of three reports concerning the allegations. This report addresses the allegation that the C-130J aircraft does not meet contract specifications and therefore cannot perform its operational mission.

Id. at i.

into hostile areas.⁷ The aircraft is a medium range, tactical aircraft with multiple military service branch applications, including weather reconnaissance, electronic warfare missions, air-refueling missions, and search and rescue missions.⁸ At the inception of the procurement, the government contracting officer deemed the aircraft to be commercial, which relieved Lockheed Martin of producing certified cost or pricing data to justify its pricing.⁹ Congress appropriated just over \$4 billion for the C-130J development between 1996 and 2004.¹⁰ In its 2004 report, DoDIG determined that the aircraft was not commercial in nature,¹¹ the Air Force failed to properly manage the development program,¹² and the

⁷ See *id.*; see also Dana Leibelson, *We Pause for this Commercial ... Sale*, TIME (May 22, 2012), <http://nation.time.com/2012/05/22/we-pause-for-this-commercial-sale/> [<http://perma.cc/KN6Z-V6TY>].

⁸ See U.S. DEPT OF DEF. INSPECTOR GEN., *supra* note 6 at 1. The C-130J was developed for use by the Air Mobility Command, Theater Commands, Air National Guard, Air Force Reserve, Air Force Special Operations Command, Marine Corps, and Coast Guard. *Id.*

⁹ See *id.* at 1–2. “Because of the contracting officer’s decision to designate the aircraft as a commercial item, Federal Acquisition Regulation Part 15, Contracting by Negotiation, which allowed access to contractor cost and pricing data as well as other Government oversight, did not have to be applied to the C-130J procurement.” *Id.* at 2.

¹⁰ See *id.* at 1.

The contracting officer’s justification that the aircraft was commercial and the decision to pursue a commercial acquisition strategy were flawed in several ways. First, the contracting officer stated that 95 percent of the features between the military and civilian versions of the aircraft were the same; however, Air Force contracting personnel could not provide the evidence to support that statement. The contracting officer also stated that the aircraft evolved from a series of Lockheed Martin-produced commercial aircraft. However, the most current prior version, the C-130H was only used for government purposes. The contracting officer also could not produce support for the determination that modification to include customer requirements would be minor. The Air Force was also unable to show that the commercial specification was compared to operational requirements and would meet Government needs.

Id. at 5.

¹¹ See *id.* at 5.

¹² See *id.* at 6.

Office of the Secretary of Defense did not provide effective oversight of the C-130J Program to correct significant program deficiencies.¹³ The report further noted that 851 deficiencies had been issued by the C-130J end users.¹⁴ Further, the government

The Air Force did not adequately manage program operations or financing for the C-130J. Since 1996, the Air Force issued three, consecutive, firm-fixed-price contracts for the C-130J aircraft even though Lockheed Martin continued to show little progress in delivering contract-compliant aircraft. In addition, the Air Force did not withhold sufficient funds from Lockheed Martin to adequately motivate the contractor to build a compliant aircraft and correct deficiencies in delivered aircraft.

Id.

¹³ *See id.* at 3.

In addition to the deficiencies in Air Force management of the C-130J aircraft, higher-level DoD officials were informed and involved in the decision process and should have acted to assist in correcting cost, schedule, and performance problems in the program. Since September 1995, when the Air Force became the milestone decision authority, the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics has provided limited oversight of the C-130J Program. However, officials in the Office of the Under Secretary of Defense were fully aware of the acquisition strategy, the changes to the operational requirements document, and the deficiency reports on the C-130J Program, but they did not act to assist the Air Force in correcting known problems or improve the management of the troubled program. Further, the Office of the Secretary of Defense supported the multiyear contract by submitting a report to Congress for approval of the multiyear contract, even though the C-130J design was not stable and the C-130 aircraft did not meet the contract model specification or operational requirements.

Id. at 8.

¹⁴ *See id.* at 4.

Air Force and Navy testers and the C-130J users generated deficiency reports that addressed commercial model specifications and operational deficiencies. The deficiencies fell into two categories. Category 1 deficiencies could cause death, severe injury or illness, major loss of equipment or systems, or directly restrict combat or operational readiness, if uncorrected. Category 2 deficiencies were all other deficiencies that did not meet the criteria of Category 1. Table 2 shows the number of open and closed deficiency reports generated on the C-130J Program as of December 31, 2003.

and Lockheed Martin were required to retrofit the delivered aircraft to compensate for the deficiency reports.¹⁵ Even more embarrassing for the Air Force was the fact that it “conditionally accepted 50 C-130J aircraft at a cost of \$2.6 billion even though none of the aircraft met commercial contract specifications or operational requirements.”¹⁶ Another cited consequence of the Air Force’s decision to deem the purchase commercial was a price adjustment made to a wiring harness.¹⁷ The wiring harness was originally priced at \$91 each, but after the Air Force’s commercial determination, the price increased to \$453 each.¹⁸ The report concluded that allegations that the C-130J aircraft did not meet contract specifications and was unable to perform its operational mission were substantiated.¹⁹

This Article takes an in-depth look at the federal commerciality regulations. Part I reviews the Federal Acquisition Streamlining Act, which is the federal law that initially encouraged the federal government to procure more commercial items and contractors to adopt more commercial market practices. Part II discusses FAR Part 12, which provides specific guidance on the treatment of commercial goods and services in federal contracting. Part III notes specific regulatory and practical problems with the existing commerciality regulations. Part IV provides concrete steps and language to improve the commerciality regulations. This Article concludes that the current commerciality regulations create far too much confusion, which leads to waste in federal contracting.

TABLE 2. C-130J DEFICIENCY REPORTS
(AS OF DECEMBER 31, 2003)

| | Category 1 | Category 2 | Total |
|--------|------------|------------|-------|
| Open | 33 | 151 | 184 |
| Closed | 135 | 532 | 667 |
| Total | 168 | 683 | 851 |

Id.

¹⁵ *See id.* at 4.

¹⁶ *Id.* at 3.

¹⁷ Leibelson, *supra* note 7.

¹⁸ *See id.*

¹⁹ *See* U.S. DEP’T OF DEF. INSPECTOR GEN., *supra* note 6 at i. “We substantiated the allegation that the C-130J aircraft does not meet contract specifications and therefore cannot perform its operational mission.” *Id.*

This waste can be remedied by taking a practical review and re-writing the regulations.

I. A MOVE TO NORMALIZE THE FEDERAL CONTRACTING MARKET:
THE FEDERAL ACQUISITION STREAMLINING ACT OF 1994

*There was a general recognition that the procurement process had become overly complex. ... Some of it related to the competition requirements to cost and pricing data that vendors were required to provide to the regulations that focused, in the view of some people, more on process than on outcomes.*²⁰

A. *Wartime Story Highlights the Need for Change*

Over the years, there have been a number of famous stories related to the rigidity of the federal procurement process. One such story that had a great impact dates back to the early 1990s. During Operation Desert Storm, the United States Army was in need of two-way radios.²¹ Motorola, a large American telecommunications company, produced a radio for various law enforcement entities that seemingly matched the Army's stated criteria.²² The parties could not make the procurement work, as federal law prohibited the Army from making the procurement.²³ Specifically, federal law required that the price offered to the Army be the lowest price offered to anyone, anywhere, for the radios in question, and that Motorola would be required to sign a certificate to that fact.²⁴ Motorola could not make such a guarantee²⁵ and, consequently, could not sign a certificate in support of the federal requirement.²⁶ Purportedly, the Army attempted to get a waiver

²⁰ Michael O'Connell, *Federal Acquisition Streamlining Act (1994)* FED. NEWS RADIO (June 8, 2012), <http://federalnewsradio.com/acquisition/2012/06/federal-acquisition-streamlining-act-1994/> [<http://perma.cc/9LXQ-D6V9>] (quoting William Woods, former Director of Acquisition and Sourcing Management, Government Accountability Office).

²¹ See JACQUES S. GANSLER, *DEFENSE CONVERSION* 119 (1995).

²² See *id.* at 119.

²³ See *id.*

²⁴ *Id.*

²⁵ *Id.* Motorola could not make such a claim because it sold the same product to local police departments through distributors and was not privy to the price paid by the individual police departments. *Id.*

²⁶ *Id.*

of the requirements to procure the radios, but was unsuccessful.²⁷ Ultimately, a compromise solution developed.²⁸ The Japanese government purchased the radios from Motorola on behalf of the United States Army as part of its contribution toward supporting Operation Desert Storm.²⁹

B. Congressional Action Is Taken to Remedy the Situation

In 1994, after a number of reform panels and studies had been conducted on the federal contracting arena and process, and after hearing stories such as the United States Army-Motorola debacle, Congress passed the Federal Acquisition Streamlining Act of 1994 (FASA).³⁰ FASA made sweeping changes to federal contracting, including increasing the small purchase threshold.³¹ Other changes were also made regarding competition,³² truth in negotiations,³³ procurement protests,³⁴ and small business and socioeconomic laws.³⁵ One of the more significant changes revolved around the federal government's procurement of commercial items. Specifically, the law established the definition of commercial items,³⁶ required the inclusion of contract clauses to

²⁷ *Id.* "The army attempted to get someone at a high political level in the army to sign a waiver on this law, but was unsuccessful. No one was authorized to violate the law without congressional approval." *Id.*

²⁸ *See id.*

²⁹ *Id.* "The solution to this dilemma was to have Japan purchase the radios from Motorola and then supply them to the U.S. Army as part of Japan's contribution to Operation Desert Storm." *Id.*

³⁰ Pub. L. No. 103-355, 108 Stat. 3243. *See generally* Nathanael Causey et al., *1994 Contract Law Developments—The Year in Review*, in DEP'T OF THE ARMY, THE ARMY LAWYER, DEP'T OF THE ARMY PAMPHLET 27-50-267 (Feb. 1995) at 3.

³¹ *See* § 4001, 108 Stat. at 3338. The law changed the small purchase threshold from \$25,000 to \$100,000. *See id.*

³² *See id.* §§ 1001–93.

³³ *See id.* §§ 1201–52.

³⁴ *See id.* §§ 1401–39.

³⁵ *See id.* §§ 7101–206.

³⁶ *See id.* § 8001(a). The definition reads:

(A) Any item, other than real property, that is of a type customarily used by the general public or by non-governmental entities for purposes other than governmental purposes, and that—

cover commercial items in the FAR,³⁷ set the guidelines for agencies to accept commercial items,³⁸ created a preference for the

(i) has been sold, leased, or licensed to the general public;
or

(ii) has been offered for sale, lease, or license to the general public.

(B) Any item that evolved from an item described in subparagraph (A) through advances in technology or performance and that is not yet available in the commercial marketplace, but will be available in the commercial marketplace in time to satisfy the delivery requirements under a Federal Government solicitation.

(C) Any item that, but for—

(i) modifications of a type customarily available in the commercial marketplace, or

(ii) minor modifications made to meet Federal Government requirements, would satisfy the criteria in subparagraph (A) or (B).

(D) Any combination of items meeting the requirements of subparagraph (A), (B), (C), or (E) that are of a type customarily combined and sold in combination to the general public.

(E) Installation services, maintenance services, repair services, training services, and other services if such services are procured for support of an item referred to in subparagraph (A), (B), (C), or (D) and if the source of such services—

(i) offers such services to the general public and the Federal Government contemporaneously and under similar terms and conditions; and

(ii) offers to use the same work force for providing the Federal Government with such services as the source uses for providing such services to the general public.

(F) Services offered and sold competitively, in substantial quantities, in the commercial marketplace based on established catalog prices for specific tasks performed and under standard commercial terms and conditions.

(G) Any item, combination of items, or service referred to in subparagraphs (A) through (F) notwithstanding the fact that the item, combination of items, or service is transferred between or among separate divisions, subsidiaries, or affiliates of a contractor.

(H) A nondevelopmental item, if the procuring agency determines, in accordance with conditions set forth in the Federal Acquisition Regulation, that the item was developed exclusively at private expense and has been sold in substantial quantities, on a competitive basis, to multiple State and local governments.

Id.

³⁷ *See id.* § 8002(b).

³⁸ *See id.* § 8002(c). The provision states:

acquisition of commercial items,³⁹ and created a presumption that technical data under contracts for commercial items were developed exclusively at private expense.⁴⁰ These key commercial provisions had the overt goal of making procurement of commercial items easier, especially for those companies not entirely familiar with the federal government as a customer.⁴¹ The law was signed

The Federal Acquisition Regulation shall provide that under appropriate conditions the head of an executive agency may require offerors to demonstrate that the items offered—

(A) have either—

- (i) achieved commercial market acceptance; or
- (ii) been satisfactorily supplied to an executive agency under current or recent contracts for the same or similar requirements; and

(B) otherwise meet the item description, specifications, or other criteria prescribed in the public notice and solicitation relating to the contract.

(2) The Federal Acquisition Regulation shall provide guidance to ensure that the criteria for determining commercial market acceptance include the consideration of—

(A) the minimum needs of the executive agency concerned; and

(B) the entire relevant commercial market, including small businesses.

Id.

³⁹ *See id.* § 8104. The law notes:

The head of an agency shall ensure that, to the maximum extent practicable—

(1) requirements of the agency with respect to a procurement of supplies or services are stated in terms of—

- (A) functions to be performed;
- (B) performance required; or
- (C) essential physical characteristics;

(2) such requirements are defined so that commercial items or, to the extent that commercial items suitable to meet the agency's needs are not available, nondevelopmental items other than commercial items, may be procured to fulfill such requirements; and

(3) offerors of commercial items and nondevelopmental items other than commercial items are provided an opportunity to compete in any procurement to fill such requirements.

Id.

⁴⁰ *See id.* § 8106.

⁴¹ *See generally* S. REP. NO. 103-258, at 1–3 (1994).

by President Bill Clinton on October 13, 1994, and created a platform for significant changes to the FAR.⁴²

II. IMPLEMENTATION: CHANGING THE FEDERAL ACQUISITION REGULATION TO BETTER ACCOMMODATE COMMERCIAL PROCUREMENTS BY THE FEDERAL GOVERNMENT

The procurement regulatory changes embodied in FASA were implemented in the FAR, mostly in FAR Part 12.⁴³ In implementing FASA, the FAR has eight different important provisions. First, the regulations make commercial item procurements subject to the FAR, and if there is an inconsistency created by another provision of the FAR, Part 12 prevails.⁴⁴ Second, the regulations require that federal agencies consider contractor past performance data, inside and outside of the government, in the procurement of commercial items.⁴⁵ Third, the regulations require, except in specified circumstances, commercial procurements to result in firm fixed price contracts or fixed price contracts with economic adjustments.⁴⁶ Fourth, while maintaining a price reasonableness

⁴² See Causey, et al., *supra* note 30, at 3, 12 n.128.

⁴³ See 48 C.F.R. § 12 (2014).

⁴⁴ See 48 C.F.R. § 12.102(c) (2014). The provision states, “Contracts for the acquisition of commercial items are subject to the policies in other parts of the FAR. When a policy in another part of the FAR is inconsistent with a policy in this part, this part 12 shall take precedence for the acquisition of commercial items.” *Id.*

⁴⁵ See 48 C.F.R. § 12.206 (2014). The regulation notes:

Past performance should be an important element of every evaluation and contract award for commercial items. Contracting officers should consider past performance data from a wide variety of sources both inside and outside the Federal Government in accordance with the policies and procedures contained in subpart 9.1, section 13.106, or subpart 15.3, as applicable.

Id.

⁴⁶ See 48 C.F.R. § 12.207 (2014).

(b)(1) A time-and-materials contract or labor-hour contract (see Subpart 16.6) may be used for the acquisition of commercial services when-

- (i) The service is acquired under a contract awarded using—
 - (A) Competitive procedures (*e.g.*, the procedures in 6.102, the set-aside procedures in Subpart 19.5, or competition conducted in accordance with Part 13);

determination standard for commercial items, the regulations direct that agencies also take into consideration, as part of those determinations, several factors which may affect or impact commercial practices and therefore, commercial pricing.⁴⁷ Fifth, the

-
- (B) The procedures for other than full and open competition in 6.3 provided the agency receives offers that satisfy the Government's expressed requirement from two or more responsible offerors; or
 - (C) The fair opportunity procedures in 16.505 (including discretionary small business set-asides under 16.505(b)(2)(i)(F)), if placing an order under a multiple-award delivery-order contract; and
 - (ii) The contracting officer—
 - (A) Executes a determination and findings (D&F) for the contract, in accordance with paragraph (b)(2) of this section (but see paragraph (c) of this section for indefinite-delivery contracts), that no other contract type authorized by this subpart is suitable;
 - (B) Includes a ceiling price in the contract or order that the contractor exceeds at its own risk; and
 - (C) Prior to increasing the ceiling price of a time-and-materials or labor-hour contract or order, shall—
 - (1) Conduct an analysis of pricing and other relevant factors to determine if the action is in the best interest of the Government;
 - (2) Document the decision in the contract or order file; and
 - (3) When making a change that modifies the general scope of—
 - (i) A contract, follow the procedures at 6.303;
 - (ii) An order issued under the Federal Supply Schedules, follow the procedures at 8.405-6; or
 - (iii) An order issued under multiple award task and delivery order contracts, follow the procedures at 16.505(b)(2).

Id.

⁴⁷ See 48 C.F.R. § 12.209 (2014).

While the contracting officer must establish price reasonableness in accordance with 13.106-3, 14.408-2, or subpart 15.4, as applicable, the contracting officer should be aware of customary commercial terms and conditions when pricing commercial items. Commercial item prices are affected by factors that include, but are not limited to, speed of delivery, length and extent of warranty, limitations of seller's liability, quantities ordered, length of the performance period, and specific performance requirements. The contracting officer must ensure

regulations specifically restrict the utilization of governmental Cost Accounting Standards for commercial item procurements in firm-fixed-price and fixed-price with economic adjustment contracts.⁴⁸ Sixth, the regulations create a special acceptance standard for commercial items.⁴⁹ Specifically, the regulation states that acceptance of commercial items is “based upon the assumption that the Government will rely on the contractor’s assurances that the commercial item tendered for acceptance conforms to the contract requirements.”⁵⁰ Even with this special acceptance clause, the Government still maintains the right to reject nonconforming items.⁵¹ Seventh, specific regulations are excluded from applicability to commercial item procurements.⁵² In prime contracts, the application of a diverse group of regulations is excluded, including for contingent fees,⁵³ drug-free workplaces,⁵⁴ truthful cost or pricing data,⁵⁵ the Truth in Negotiations Act,⁵⁶ and Cost Accounting

that contract terms, conditions, and prices are commensurate with the Government’s need.

Id.

⁴⁸ See 48 C.F.R. § 12.214 (2014). The regulations read:

Cost Accounting Standards (CAS) do not apply to contracts and subcontracts for the acquisition of commercial items when these contracts and subcontracts are firm-fixed-price or fixed-price with economic price adjustment (provided that the price adjustment is not based on actual costs incurred). See 48 CFR 30.201-1 for CAS applicability to fixed-price with economic price adjustment contracts and subcontracts for commercial items when the price adjustment is based on actual costs incurred. When CAS applies, the contracting officer shall insert the appropriate provisions and clauses as prescribed in 48 CFR 30.201.

Id.

⁴⁹ See 48 C.F.R. § 12.402 (2014).

⁵⁰ *Id.*

⁵¹ See *id.*

⁵² See 48 C.F.R. § 12.503 (2014); 48 C.F.R. § 12.504 (2014).

⁵³ See 48 C.F.R. § 12.503(a)(2) (2014). Under FAR Subpart 3.4, contractors are prohibited from paying contingent fees for soliciting or obtaining Government contracts except in specified situations. See *generally* 48 C.F.R. § 3.402.

⁵⁴ See 48 C.F.R. § 12.503(a)(4) (2014). Under FAR Subpart 23.504, contractors are required to provide a drug-free workplace and using a number of specific means to comply with the regulations. See *generally* 48 C.F.R. § 23.504 (2014).

⁵⁵ See 48 C.F.R. § 12.503(c)(2) (2014).

⁵⁶ See *id.* See *generally* 48 C.F.R. § 15.4 (2014).

Standards.⁵⁷ In subcontracts, the same regulations are excluded, plus Validation of Proprietary Data restrictions,⁵⁸ Examination of Records of Contractor,⁵⁹ and Transportation in American Vessels of Government Personnel and Certain Cargo.⁶⁰ Finally, the regulations provide for streamlined evaluation processes⁶¹ and solicitations for commercial item offerors.⁶²

III. A MORE COMPLICATED REALITY: SPECIFIC PROBLEMS WITH THE COMMERCIALITY REGULATIONS

*The overly broad definition of commercial item currently in effect affords items which are not truly commercial items and which are not sold to the general public to qualify as commercial items and as a result, contracting officers are unable to acquire the necessary data to make the price reasonableness determination.*⁶³

As previously mentioned, the United States Government spends over \$400 billion annually in contracting.⁶⁴ Those procurements include goods and services from a vast array of fields.⁶⁵ Thus, the commerciality regulations have to be broad enough to encompass the wide array of commercial procurements by the federal government.⁶⁶ As currently written, the regulations fail to accomplish that goal, but instead serve to create more confusion.

⁵⁷ See 48 C.F.R. § 12.503(c)(3) (2014).

⁵⁸ See *id.* § 12.504(a)(5).

⁵⁹ See *id.* § 12.504(a)(7).

⁶⁰ See *id.* § 12.504(a)(11).

⁶¹ See 48 C.F.R. § 12.602 (2014). Under this FAR provision, “[F]or many commercial items, the criteria need not be more detailed than technical (capability of the item offered to meet the agency need), price and past performance.” *Id.*

⁶² See generally 48 C.F.R. § 12.603. The regulation states, if utilized, certain data requirements and certification statements. See *id.*

⁶³ Amber Corrin, *Acquisition abuse drives DOD to reassess commercial purchase rules*, DEF. SYS. (May 2, 2012), <http://defensesystems.com/articles/2012/05/01/dod-of-a-type-contract-rule-changes.aspx> [<http://perma.cc/BNY5-QLAF>] (quoting United States Department of Defense Spokeswoman Cheryl Irwin).

⁶⁴ See Medici, *supra* note 5.

⁶⁵ See *id.*

⁶⁶ See *id.*

A. The Definition of a Commercial Item Is Problematic

Currently, the lengthy definition of commercial item, when condensed, is any item other than real property that is of a type customarily used by the general public or by non-governmental entities for purposes other than governmental purposes, and has been sold or leased or offered for sale or lease.⁶⁷ This definition does little to differentiate between a commercial and non-commercial item. For instance, two-way radios, such as those previously mentioned, could have both governmental and non-governmental applications. There are a multitude of brands and types of two-way radios. How does this definition differentiate between governmental and non-governmental application? This is not an issue where an item has straightforward commercial application. For instance, imagine a single copier machine model that is sold to both governmental and non-governmental clients. The same copier is made available regardless of the customer or end user. There is no question that the copier would neatly and easily fit into the commercial item definition. Another example that may fit into the definition is aircraft parts. Aircraft parts that are the same would meet the definition, whether they are used on commercial jetliners or specialized military aircraft. However, there are many more complicated scenarios to determining commerciality. Consider the following hypothetical to see the confusion:

The Aliazon Group (TAG) develops a two-way radio that is sold in a publicly available catalog to farmers and the agriculture industry. The radios have a range of twenty-five miles, have a special metallic coating to make them weatherproof, and come in eight different colors. TAG subsequently develops a two-way radio specifically for military use. The radios have a twenty-five mile radius, have a special metallic weatherproof coating, come in only one color, have a special shock resistant rubber case, and are sold special order. Both versions of the two-way radios use the same technology, electrical components, and are made on the same assembly line. The only differences are that the military use radios only come in one color and have a shock resistant rubber case.

⁶⁷ Federal Acquisition Streamlining Act of 1994, Pub. L. No. 103-355, § 8001, 108 Stat. 3243, 3385 (1994).

Using the current definition provides no easy answer as to whether the military use radio is really a commercial item. On its face, the military radio is the same type as those used by the farm and agriculture industries. The farm and agriculture version is sold through a public catalog. Therefore, as the radios are so similar, it would seem the military version of the radio should easily meet the criteria for a commercial item. However, there is an argument that the military version is not of the same type because it has an additional case that serves a different purpose, and is not available through a public catalog. Thus, the general public would not have access to that exact radio.

A second issue with the broader commerciality definition is in defining eligible services. Specifically, the definition states “[S]ervices offered and sold competitively, in substantial quantities, in the commercial marketplace based on established catalog prices for specific tasks performed and under standard commercial terms and conditions.”⁶⁸ The definition is problematic because it points to the need for competition, sales in substantial quantities, and standard commercial terms and conditions. In the commercial market, companies routinely agree to link their services and no other service providers are invited to participate.⁶⁹ For example, Hemdan Enterprises (Hemdan) manufactures and sells copier machines that are used, without changes, by both private companies and federal, state, and local governments. Hemdan has a commercial agreement with Al Dakhil, Inc. (AD) to provide all of the warranty and repair services for those copier machines. AD provides these services exclusively, does not have commercial contracts with any other companies, and dedicates its workforce solely to Hemdan copier machine repair and warranty work. When Hemdan sells one of its copiers, it includes a price list of all warranty and repair work and clearly denotes the services can only be provided by AD in the sales agreement with the customer. Hemdan sold 750,000 copier machines in 2014 and AD had over 50,000 service or warranty calls in support of Hemdan. If AD attempted to provide separate repair services for the Hemdan copiers sold directly to the government, could it claim commerciality for its services?

⁶⁸ *Id.*

⁶⁹ *See generally* Phoenix Techs. v. Quotron Sys., No. 94-2068, 1997 U.S. Dist. LEXIS 5742, at *36–37 (E.D. Pa. 1997).

Clearly, based on the hypothetical, AD has provided its services in a commercial setting, has a commercial price list that is distributed to all Hemdan customers, and has a sales agreement with the customers, which serves as the terms and conditions for AD's business. However, there seems to be the missing variable of "competition." Additionally, the regulation does not define "competition." Could the competition for AD to get the agreement with Hemdan fulfill the agreement? Hemdan has competitors who sell copier machines and the government could have considered any number of those competitors. Could that serve as the basis for competition? In short, the absence of a definition for competition is too vague.

Second, the regulation requires a substantial quantity of sales for the services.⁷⁰ In the hypothetical above, AD had 50,000 repair and warranty calls on behalf of Hemdan in 2014. Is that substantial enough justification for the regulatory provision? The repair and warranty calls impacted only 6 percent of the Hemdan copier machines sold in 2014. What if AD only had 1,000 repair and warranty calls in 2014, thereby impacting less than 1 percent of Hemdan copier machines sold? The definition of "substantial quantities" is opaque and leaves unnecessary discretion to a decision maker.

Third, the provision requires utilization of standard commercial terms and conditions.⁷¹ What constitutes standard commercial terms and conditions? Is it related to the copier machine industry standard? Is it related to the warranty and repair work industry? What if Hemdan, and AD vicariously, developed terms and conditions that are different than other copier machine retailers? They have made what is seemingly a large number of sales and warranty and repair calls, so does that make the arrangement standard? Finally, how could AD prove what are standard terms and conditions, especially if it does not have privity to other similar competitor agreements? It is clear that once again, the lack of a clear definition creates an indistinct requirement that is hazy at best.

⁷⁰ Federal Acquisition Streamlining Act, Pub. L. No. 103-355, § 8001, 108 Stat. 3243 (1994).

⁷¹ *Id.*

Therefore, the definitions for both commercial items and services create a level of ambiguity that will ensure imprecise applications of the law.

B. Past Performance Data Consideration

The regulations place great importance on the consideration of past performance of a commercial contractor. Specifically, the regulations require that a contracting officer consider past performance data from a plethora of sources, both inside and outside of the federal government.⁷² While requiring past performance consideration is a best practice, the concern with this specific requirement is the sourcing of such data.⁷³ The provision places no limits on the data considered and, therefore, could lead to the consideration of data that is irrelevant or flawed. In the Internet Age, there are a number of sources that may have dubious credibility, and there is nothing restricting information from these sources from being considered. For example, imagine the United States Department of Treasury is considering an award to Harden Solutions (Harden) for laptops. Harden has not provided laptops to the United States government before, so there is no past performance data available in governmental sources. Unbeknownst to the contracting officer, Harden had provided the model of laptop in question to a number of municipal governments, but in much smaller numbers than those required in the Treasury Department solicitation. The laptops are clearly a commercial item, and in considering an award to Harden, the contracting officer does an internet search for Harden and user reviews of its proposed product. The contracting officer finds five websites that produce these reviews. Four of the sites have overwhelmingly negative reviews of the laptop, raising concerns about the durability of the item, and give low assessments of Harden's customer service and repair capability. The fifth website has reviews that are generally positive toward the laptop and Harden. Although all of the sites are tied to major consumer magazines, the user reviews are unedited and monitored strictly for inappropriate language. Based on the nebulous language in the law, the contracting officer could use the information he obtained on the four websites as the basis

⁷² Federal Acquisition Regulations System, 48 C.F.R. § 12.206 (2014).

⁷³ *Id.*

for not awarding the contract to Harden. In the reverse, the contracting officer could also choose to give more weight or credence to the fifth website and award to Harden in the face of what seems overwhelming evidence of issues. Regardless of the outcome, consideration of such uncorroborated information places Harden in an unfair position. There is nothing in the law, or in the supporting regulations, that could stop a scenario like this example from happening.

Additionally, the laws create no boundary for the quality or depth of the past performance information considered.⁷⁴ Should a contracting officer consider five sources? Would three sources be sufficient? What numbers of sources are sufficient to reach a conclusion on a contractor's capabilities? What if the contracting officer only considers a single past performance source, and that source was provided by the contractor? In short, the vagueness of the provision could lead to nebulous past performance considerations.

C. Price Reasonableness Determination

Finally, the law requires that the proposed prices for commercial items meet the price reasonableness standard, but in doing so, consider elements of the commercial market.⁷⁵ Further, the law requires that contracting officers be aware of "customary commercial terms and conditions when pricing commercial items."⁷⁶ Additionally, FASA created a new standard for government consideration in contract awards by moving away from a lowest price concept to a best value model.⁷⁷ These two requirements create something of a conflict. It makes perfect sense for contracting officers to consider the commercial market when determining price reasonableness in its attempt to ascertain best value because the very purpose of FASA was to bring the United States Government more in line with commercial practices. However, those commercial market considerations should

⁷⁴ *Id.*

⁷⁵ 48 C.F.R. § 12.209 (2014).

⁷⁶ *Id.*

⁷⁷ 48 C.F.R. § 15.303(b)(6) (2014) ("The source selection authority shall ... [s]elect the source or sources whose proposal is the best value to the Government"); 48 C.F.R. § 12.209.

not trump the government's need for best value. It is impractical to think that contracting officers can become aware, with any depth and intelligence, of customary commercial practices across the hundreds of industries providing goods and services to the government. Further, it is not in the government's best interest to let commercial market determinations have too large a say in what constitutes best value for the government.

IV. CLEARER STANDARDS: RECOMMENDATIONS TO CORRECT COMMERCIAL ITEM REGULATORY DEFICIENCIES

Currently, contractors can label certain goods and services as "commercial," even if the items are never bought by the public. This allows contractors to avoid disclosing information about the costs of creating the product or service. The result? The government ends up paying highly questionable prices for certain items.⁷⁸

As described at the outset of this Article, there are real world consequences to utilization of the commerciality regulations. Therefore, clearer, better regulations are needed to ensure the government is protected in commercial procurements.

A. Improving the Definitions of Commercial Item and Services

The current definitions for commercial items and services are too broad and confusing for the government and for the commercial market contractors that the regulations were intended to benefit. First, the definitions should provide a clear, bright line test for application. Additionally, the definitions should have enough flexibility to compensate for the fact that the definitions will need to be applied across numerous fields. With that in mind, the following language is proposed as a new definition of commercial items:

A commercial item is defined as any item, other than real property, that meets one of the following criteria:

⁷⁸ Leibelson, *supra* note 7.

1. The item is offered, in its entirety and without change, to governmental and non-governmental entities through a publicly accessible means;
 2. The item has not been offered to any governmental or non-governmental entity and was developed at the sole expense of the contractor without any assistance by any governmental entity at any level, foreign or domestic; or
 3. The item is offered, with modification, to governmental and non-governmental entities. The modifications must be de minimis to the utilization of the item, specifically meaning that the item can still function as intended without the modification.
- In order to qualify the item as commercial, the prime contractor or subcontractor must provide sufficient information, as determined by the Contracting Officer, to meet the definitions.⁷⁹

The proposed definition seeks to address the most common situations in which commercial items are utilized. First, the most common, and most easily resolved, commercial items are those offered to both governmental and non-governmental entities, without any form of modification and made available through some publicly accessed means such as catalogs, websites, list serves, or flyers. So, to make reference to an earlier part of this Article, an example would be a copier machine that is the same regardless of the customer. The second definition is meant to cover items that have been newly developed at the sole cost of the contractor, but have not yet been offered on the open market. The definition specifically notes that expense costs borne by any government would exclude it from consideration under this definition. Finally, the third definition is meant to cover those situations where there are truly minor differences between the governmental and non-governmental application of an item. These three definitions provide enough flexibility for a commercial contractor to have items appropriately qualified, without much of the confusion that exists today. Further, the provision places the responsibility of proving commerciality on the prime contractor or subcontractor, and includes an obligation to provide enough information for the contracting officer to make an informed decision. This gives the contractor an opportunity to produce critical information and the contracting officer sufficient control over the

⁷⁹ 48 C.F.R. § 12.206.

situation to make an accurate decision and protect the government's interests.

As for commercial services, the following language is proposed:

A commercial service is defined as any service that meets one of the following criteria:

1. Services to assess, repair or remove a commercial item through publicly accessible means;
2. Technical or management services not in support of a commercial item that are available to governmental or non-governmental entities through publicly accessible means; or
3. Services, without modification, provided to governmental and non-governmental entities through publicly accessible means.

In order to qualify the service as commercial, the prime contractor or subcontractor must provide sufficient information, as determined by the Contracting Officer, to meet the definitions.⁸⁰

These definitions serve a practical purpose. First, the initial definition for commercial services is tied to commercial item support. Theoretically, it makes sense that services supporting commercial items should also be considered commercial in nature. In one of the previous hypotheticals, a company that solely provides repair and warranty support to a specific copier machine (or line of copier machines) would qualify as a commercial service under this definition. The second definition focuses on commercial services that are not necessarily tied to a commercial item. For instance, information technology consulting services would be a good candidate for this category. The consulting firm provides technical services consulting to the public at large and the only distinction in price is related to the size of the engagement. However, the expertise utilized for each customer, regardless of governmental status, is the same. The third definition is meant to serve as a "catch-all" for services that are commercial in nature, but do not fit neatly into the other two categories. Finally, as with the commercial item determination, the prime contractor or subcontractor is required to submit supporting documentation and the contracting office has the flexibility to make the necessary decision.

⁸⁰ *Id.*

B. Creating Boundaries for Past Performance Data

As previously noted,⁸¹ the current regulations do not place sufficient boundaries on information utilized in considering past performance. In creating the necessary boundaries, I contend that the contractor should be given an opportunity to provide evidence of past performance and the contracting officer should be given the freedom to consider other instances of past performance. Therefore, the following language is proposed:

The Contracting Officer shall consider past performance prior to the award of any contract containing commercial items or services. Said past performance shall be for the same or similar items or services. The order of precedence for such past performance data shall be:

1. Data from federal government sources;
2. Data from other domestic government sources; or
3. Data provided by the proposed contractor or subcontractor.

The prime contractor or subcontractor shall submit its data in tandem with its proposal. The Contracting Officer should consider at least three sources in considering past performance. If the Contracting Officer considers more or less sources, an explanation shall be provided to the Head of the Contracting Activity upon award.

The proposed language creates a clear order of precedence when considering past performance because it will address the issue of imbalanced application of the regulations. First, the best source for relevant past performance is the federal government's own sources. The federal government has an extensive contractor evaluation process with a primary purpose of determining contractor past performance. The second source is for state, local, and municipal governments that may also collect such data. The premise is that many domestic (i.e. non-federal U.S. governmental bodies) also do business with commercial contractors, and utilizing any data these governments have stored would be helpful. Third, the proposed language gives contractors or subcontractors the opportunity to submit past performance data. There may be instances whereby the contractor has not provided the items or services to a governmental entity and this will give

⁸¹ *Id.*

the contracting officer a starting point to consider past performance. Finally, the proposed language states that the contracting officer should consider at least three sources for past performance data, and creates an obligation to explain to the Head of the Contracting Activity if more or fewer sources are considered. This addresses the issue of the breadth and depth a contracting officer must go through in past performance. By placing controlled boundaries, and giving the contractor an opportunity to weigh in, it levels the playing field.

C. Unambiguous Guidance on Price Reasonableness

As previously noted, there is no disagreement with placing a price reasonableness requirement on the procurement of commercial items and services. However, the factors the contracting officer should consider must ensure the federal government gets the best value in its procurements. To that end, the following language is proposed:

The Contracting Officer shall award contracts for commercial items only after determining that the offered price is fair and reasonable. In determining whether the proposed price is fair and reasonable, the Contracting Officer will consider the following factors, in this order:

1. Best value for the government as ascertained through federal pricing databases;
2. Market research;
3. Supporting documentation provided by the contractor; and Commercial market practices.

The prime contractor is responsible for the submission of its supporting documentation. Failure to submit supporting documentation, or sufficient documentation to determine price reasonableness, as determined by the Contracting Officer, may result in adverse action in the award process.

The proposed price reasonableness definition addresses a number of issues. First, it creates the primary priority of best value for the federal government. Second, it increases the responsibility of the contracting officer to conduct market research in the solicitation process. To ensure the government is not blindsided in its budgeting for procurements, it is critical that the contracting officer conduct timely, appropriate market research. Third, the proposed language places a responsibility on the contractor to

prove the price is fair and reasonable. This may be interpreted as another way of obligating the contractor to provide cost or pricing data. In fact, it is not. The contractor does not have to provide a certification for the information submitted under this proposal. Additionally, the contractor can explain why the proposed pricing is competitive and should be able to provide evidence to that end. The requirement is not as intense as the certified cost or pricing data process. Fourth, the government should use commercial market practices in determining price reasonableness. Finally, the proposed language places a direct obligation on the contractor to support price reasonableness procedure and provides for consequences if the contractor does not assist. All of this ensures that the government gets the best value, but also gives the contractor two opportunities to justify its pricing.

CONCLUSION

Congress made a valiant effort to remake the government procurement system into a true commercial marketplace. However, that effort has fallen short. The current regulations that support commercial procurement utilize ambiguous definitions, provide poor guidance on past performance consideration data, and offer conflicting standards for determining price reasonableness. By strengthening the regulations through clear and unambiguous rewrites, the government could close some of the wide loopholes in the law. Failure to do so will result in more financial fiascos, such as the Lockheed Martin C-130J aircraft.⁸² A few strokes of the pen could save American taxpayers billions of dollars. Does Congress have the intestinal fortitude to make it happen? A strong, efficient federal procurement system is riding on the answer.

⁸² U.S. DEP'T OF DEF. INSPECTOR GEN., *supra* note 6.