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¶ 79

FEATURE COMMENT: Significant Changes In Government Contracts Domestic Preference Requirements May Be On The Horizon

Within the first few weeks of taking office, President Donald Trump swiftly acted on one of his campaign's signature agenda items: "Buy American and Hire American." Throughout the campaign, the president touted his ability and desire to grow America's economy by bringing jobs back to the U.S. and strengthening the country's manufacturing and industrial bases. Just three days after his inauguration, the president issued a presidential memorandum directing the U.S. trade representative to withdraw the U.S. from the Trans-Pacific Partnership and to pursue bilateral trade agreements that promote U.S. industry and workers. The president further promoted his agenda by signing presidential memos relating to the Keystone XL and Dakota Access pipelines, requiring the pipelines to use certain steel and other goods manufactured in the U.S. to the maximum extent possible. Most recently, the Trump Administration announced that it is exploring the possibility of bypassing the World Trade Organization (WTO) rules on dispute resolution so that the U.S. can unilaterally levy trade sanctions against China and other countries.

Since taking office, the president has also demonstrated his willingness to shake up federal procurement practices by expressing his desires to increase cost efficiencies associated with defense spending. For example, in a Dec. 22, 2016 post on Twitter, then President-elect Trump wrote "[b]ased on the tremendous cost and cost overruns of the Lockheed Martin F-35, I have asked Boeing to price-out a comparable F-18 Super Hornet!" Putting the president's words into action, Pentagon chief James Mattis asked Deputy Defense Secretary Robert Work to oversee a review of the two jets and determine whether an improved Boeing F-18 could provide a "competitive, cost effective, fighter aircraft alternative" to Lockheed Martin's F-35. Samantha Masunaga, "Defense secretary orders review of F-35 fighter jet program, and will compare F-35C to Super Hornet," *L.A. Times* (Jan. 17, 2017), *www.latimes.com/business/la-fi-f35-review-20170127-story.html*.

Given the president's stance on trade and domestic preference issues, his actions in pitting Boeing against Lockheed may demonstrate the administration's willingness to terminate Government contracts for convenience if the contract's objectives and the contractor's execution do not align completely with his "Buy American and Hire American" vision. Government contractors therefore should note the new administration's trade policy objectives and how these policies may affect Government contracts domestic preference requirements. Contractors also should prepare for heightened enforcement activity in this area as the president mounts a full-court press for "Buy American and Hire American."

This Feature Comment examines the two primary domestic preference regimes that affect Government contracts—the Buy American Act of 1933 (BAA) and the Trade Agreements Act of 1979 (TAA). It then discusses potential changes the president might unilaterally make to these domestic preference regimes' implementing regulations, and explores how these changes might affect Government contractors. Finally, this Feature Comment outlines potential changes in the Government's enforcement of domestic preference compliance requirements, particularly in the wake of the Court of International Trade's (CIT's) recent *Energizer Battery* decision rigorously applying the TAA's substantial transformation test.

Potential Administrative and Statutory Changes to the BAA—The BAA requires the Government to offer preferential treatment to domestic end products in certain federal procurements and contract awards. In practice, the BAA's preferential treatment is implemented by establishing price preferences for domestic offers (i.e., those offers consisting of domestic end products or domestic construction materials). Once a contract subject to the BAA is awarded, a contractor must deliver only domestic end products, or face potential contractual, or even False Claims Act, liability. Federal Acquisition Regulation 52.225-2(d); see e.g., *U.S. v. Rule Indus., Inc.*, 878 F.2d 535 (1st Cir. 1989).

Domestic end products are products that are manufactured in the U.S. using predominantly articles, materials and supplies that originate from the U.S. Determining whether a product qualifies as a domestic end product is a function of both statute and regulation. The BAA's statutory language essentially states that "allowable materials" include (1) unmanufactured end products or construction materials mined or produced in the U.S., and (2) manufactured end products or construction materials that are manufactured "*substantially all* from articles, materials, or supplies mined, produced, or manufactured in the United States." 41 USCA § 8302(a)(1) (emphasis added). These statutory requirements are implemented in FAR pt. 25 (as well as Department of Defense FAR Supplement pt. 225).

The FAR Council has interpreted the BAA's "substantially all" requirement to mean that "[t]he cost of the components mined, produced, or manufactured in the United States exceeds 50 percent of the cost of all its components." FAR 25.003. The FAR Council has also determined that commercially available off-the-shelf items (COTS) that are manufactured in the U.S., regardless of the origin of products' underlying articles, materials and supplies, qualify as domestic end products for BAA purposes.

Importantly for Government contractors, because the BAA's 50-percent cost of components requirement and the COTS exception are regulatory in nature, the Trump Administration may change these requirements through executive order or regulations with little resistance. The president also has broad authority to prescribe policies and directives that he considers necessary to promote economy and efficiency in federal procurements. See, e.g., 40 USCA § 121(a). For example, to further his agenda of promoting domestic manufacturing, the president might interpret the BAA's "substantially all" mandate to require contractors to meet a 75-percent or higher domestic content threshold, and modify FAR pt. 25 accordingly. Additionally, the president could singlehandedly eliminate the COTS exception because it is not rooted in the BAA's statutory language.

Indeed, were the president to tighten the BAA's domestic content requirements, he might have bipartisan support from Congress for such action. For instance, on February 7, Rep. Daniel Lipinski (D-Ill.) introduced H.R. 904, Buy American Improvement Act of 2017, a bill designed to apply BAA rules more broadly and strengthen BAA waiver provisions. Chiefly, this legislation seeks to increase the threshold of the cost of components test from 50 percent to 75 percent, such that "the cost of the domestic components of ... articles, materials, or supplies … exceeds 75 percent of the total cost of all components of such articles, materials, or supplies." Buy American Improvement Act of 2017, H.R. 904, 115th Cong. § 102 (2017). Further, the bill would require agencies to itemize all waivers regarding domestic content, justify each waiver, identify the country of origin and product specifications for goods used pursuant to each waiver granted, and summarize the total value of acquisitions made under each waiver. As a consequence of this proposed legislation, the president may not have to act unilaterally to create meaningful change with respect to the BAA's domestic content requirements.

For Government contractors, any increase in the domestic content requirements under the BAA, whether administrative or statutory, may impact profitability if contract prices do not rise proportionally with the almost certain increased cost of obtaining the necessary domestic materials for the manufacture of end products. Moreover, a change in domestic content requirements or elimination of the COTS exception would undoubtedly require Government contractors to reevaluate their supply chains, potentially require requalification of new suppliers, and likely increase costs of meeting contract requirements.

Potential Administrative Changes to the TAA—The TAA is essentially an exception to the BAA that permits the Government to purchase products and services on a nondiscriminatory basis from those countries that have signed trade agreements with the U.S. (designated countries). The TAA therefore

permits the Government to acquire U.S.-made or designated-country end products for use on Government contracts under certain circumstances. Once a contract that is subject to the TAA is awarded, contractors must deliver either U.S.-made or designated-country end products to the Government, or face potential contractual liability or FCA claims. FAR 52.225-5(b); see e.g., *U.S. v. Smith & Nephew, Inc.*, 749 F. Supp. 2d 773 (W.D. Tenn. 2010).

As opposed to the BAA's cost of components test, the TAA requires that end products acquired by the Government be "wholly the growth, product or manufacture" of the U.S. or a designated country, or, alternatively, "substantially transformed [in the U.S. or a designated country] into a new and different article of commerce with a name, character, or use distinct from that of the article or articles from which it was transformed." See 19 USCA § 2518(4)(B); FAR 52.225-5(a); FAR 25.003; 19 CFR § 177.22. Importantly, unlike the BAA, under the TAA's substantial transformation test the country of origin of the underlying components that are ultimately incorporated into an end product is largely irrelevant. As a result, a contractor may acquire components from countries that are not a party to a qualifying trade agreement with the U.S. (e.g., China, India), transport those components to the U.S. or a designated country, and then use those components to manufacture TAA-compliant end products for delivery on Government contracts under certain circumstances.

The TAA's statutory language does not define substantial transformation; rather, the substantial transformation test is addressed in certain relevant regulations (FAR pt. 25 and DFARS pt. 225) and decisional authority (primarily advisory opinions issued by Customs and Border Protection (CBP)). Substantial transformation determinations are made "on a case-by-case basis" in reviewing "the totality of the circumstances." See Notice of Issuance of Final Determination Concerning Catheter Trays, 48 Cust. B. & Dec. 111 (2014). "In determining whether the combining of parts or materials constitutes a substantial transformation, the determinative issue is the extent of operations performed and whether the parts lose their identity and become an integral part of the new article." Id. Further, the primary considerations in determining whether a product is substantially transformed in a particular country include "[t]he country of origin of the item's components, extent of the processing that occurs within a country, and whether such processing renders a product with a new name, character and use." Id.

Importantly, the TAA grants the president broad discretion to enter into and repeal trade agreements with foreign countries. As a result, the president could repeal certain trade agreements with foreign countries, thereby restricting the foreign countries that Government contractors might conduct manufacturing operations in to meet TAA requirements for federal procurement purposes. For instance, the president has discussed renegotiating the North American Free Trade Agreement, and as noted above, recently announced that the administration is exploring ways to bypass the WTO Government Procurement Agreement's dispute resolution rules. Moreover, the U.S.' trade agreements generally provide for broad national security exceptions. See, e.g., WTO GPA, Article XXIII. The president, therefore, may significantly reduce the applicability of the TAA to federal procurements by determining that the TAA does not apply for national security reasons.

Notably for Government contractors, any changes to existing trade agreements, or to the TAA's implementing regulations, likely would be aimed at requiring contractors to purchase more raw materials from domestic sources and to manufacture more goods in the U.S. or in those countries that have qualifying trade agreements with the U.S. At a minimum, any such changes to existing trade agreements, or the TAA's implementing regulations, will require Government contractors to seriously reevaluate their supply chains and overseas manufacturing operations.

Potentially Energized Enforcement Activities—In addition to limiting the applicability of the BAA and TAA through executive orders or new regulations, the president might also increase enforcement activities under existing or potentially enhanced domestic preference requirements. The president need look no further than the recent CIT decision in *Energizer Battery, Inc. v. U.S.*, 190 F. Supp. 3d 1308 (Ct. Int'l Trade 2016), for favorable legal precedent in any future enforcement actions regarding a contractor's compliance with the TAA.

In a dramatic departure from the decisional authority that preceded it, *Energizer Battery* rigorously applied the TAA's substantial transformation test to reach its conclusion that Energizer Battery's Generation II flashlight was not substantially transformed in the U.S. for federal procurement purposes. The

flashlight at issue consisted of predominately Chinese parts, but it was assembled, tested and packaged at a facility in Vermont.

In contrast to a host of previous court and administrative decisions interpreting and applying the TAA's substantial transformation test, the CIT scrutinized Energizer's assembly process in determining that the flashlight is not a U.S. or designated-country end product and, therefore, is not eligible for preferential treatment under the TAA. Specifically, the court analyzed in great detail the length of time of the flashlight's assembly (approximately seven minutes), the complexity of the assembly functions, and the qualifications necessary to complete the assembly. Ultimately, the court concluded that the "assembly process [was] not sufficiently complex to give rise to a substantial transformation." Id. Characterizing it as a "simple assembly," the CIT determined that China was the proper country of origin of the flashlight. Id.

In comparison, many other decisions regarding the TAA's substantial transformation test do not appear to apply the same degree of scrutiny that the CIT applied in *Energizer Battery*. For example, in a recent CBP decision regarding the country of origin of a commercial treadmill, CBP essentially provided the facts, laid out the overarching principles of the TAA's substantial transformation test, and gave a brief analysis before concluding that substantial transformation occurred. See Notice of Issuance of Final Determination Concerning Certain Treadmills, 50 Cust. B. & Dec. 4 (2016). In particular, CBP examined two factual scenarios:

> the first involves welding the metal components comprising the treadmills' major subassemblies in the United States, assembling the components in the United States to form the finished product, and then partially disassembling the treadmills for shipment to U.S. customers. The second is similar to the first, except that the welding and assembly will occur in Taiwan before the finished treadmill is partially disassembled and sent to the U.S. customer.

Id. After a brief summary of the facts, which included little detail, CBP compared the two scenarios to prior rulings and determined that "the extent of U.S. or Taiwanese assembly operations is sufficiently complex and meaningful to result in a substantial transformation in both scenarios." Id.

The high-level analysis employed in the treadmill decision, which is common in many CBP decisions regarding the TAA's substantial transformation test, starkly contrasts with the CIT's lengthy and rigorous analysis applied in *Energizer Battery*. Because CIT decisions interpreting and applying the TAA's substantial transformation test are few and far between, *Energizer Battery* likely will have a significant impact on future CBP decisions applying the substantial transformation test. Moreover, the CIT's strict stance on application of the TAA's substantial transformation test may provide the Trump Administration a powerful tool in any enforcement actions against Government contractors involving TAA compliance issues.

Conclusion—The administration may be positioning itself to alter domestic preference requirements for Government contracts. Thus, the contracting community, and particularly those contractors involved in manufacturing and construction operations, should closely monitor the administration's trade policy action items and how they might affect domestic preference requirements. Contractors should also consider conducting internal risk assessments to evaluate potential financial and performance repercussions any such changes might have on their business models. Finally, if contractors find themselves the target of any enforcement activities, or are considering submitting requests for country of origin advisory opinions to CBP, contractors should be aware of the CIT's *Energizer Battery* decision and its ramifications.

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