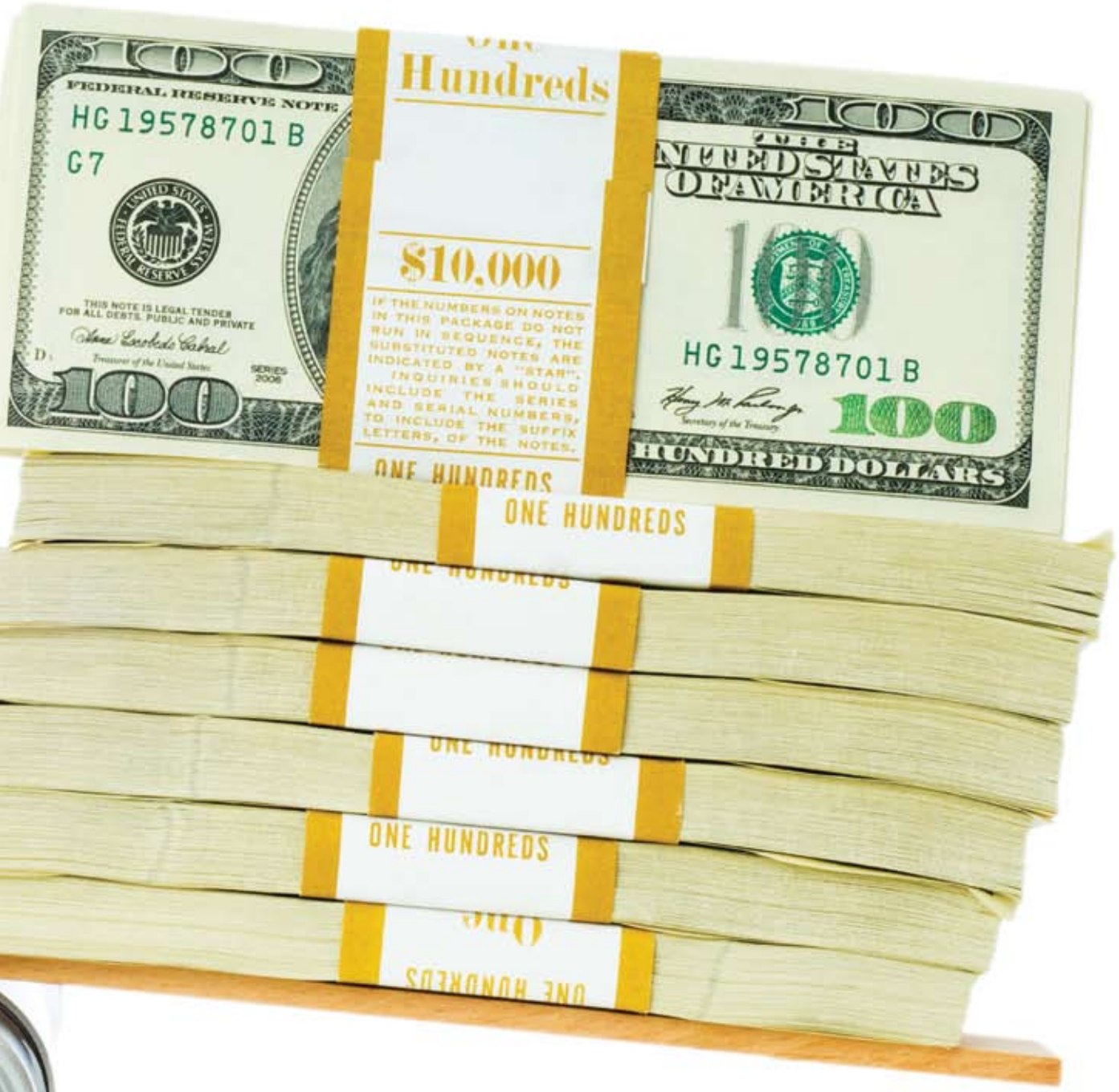
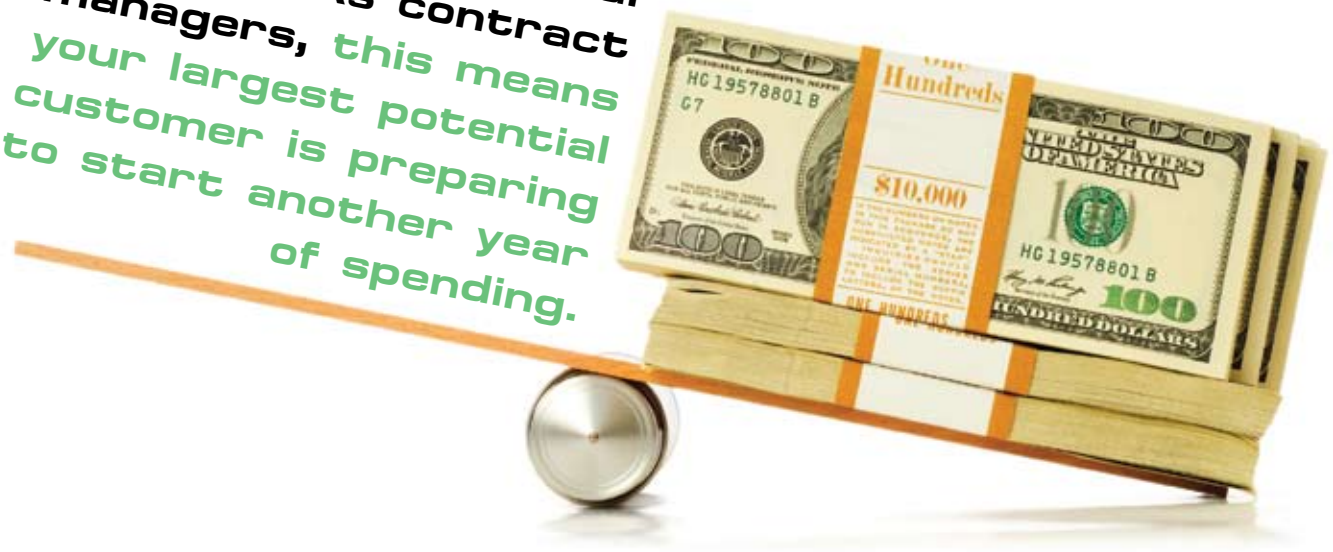
Is Your Share of the Federal Budget Worth the Compliance Costs of Becoming a Government Contractor?

A contract manager's guide to entering the massive government market with limited exposure to costly regulations.



BY SCOTT F. LANE

Over the next few months, Congress will debate the details of an estimated $3.8 trillion fiscal year 2011 federal budget.[1] As contract managers, this means your largest potential customer is preparing to start another year of spending.



Several hundred opportunities are posted by the federal government every day on **www.fedbizopps.gov**. These opportunities are not just for defense contractors. The federal government is an enormous player in commercial markets for everything from socks and portable toilets to ovens and childcare services.[2] Additionally, prime contractors are always seeking competent suppliers for raw materials and commercial components. No matter what business you are in, the federal government is the largest end customer your business can dream of having.

Despite these opportunities, many businesses vehemently avoid federal contracts and subcontracts, fearing that costly contract compliance issues will disrupt their proven business models. Others embrace the government customer and then struggle with compliance issues as they surface. Even if contract managers limit government business to commercial products or services, regulations often require affirmative action plans, prevailing wage compliance, "Buy American" provisions, intrusive disclosures, and more. These requirements could have significant costs for small and large businesses that have effectively limited or avoided exposure to federal contracts. Accordingly, it is imperative that contract managers understand the triggers and implications of these contract clauses long before they accept a federal contract or subcontract.

"Commercial Item" Status

The class of items or services being procured will determine the extent of regulatory clauses. Contracts for commercial items contain the fewest compliance requirements.[3]

Commercial items include items "of a type" customarily sold to and used by the general public or nongovernmental entities.[4] Minor modifications made to meet government requirements that do not significantly alter the function do not generally dissolve commercial item status. Certain services can also fall within commercial item status. The examples mentioned earlier are forms of commercial items. If your business limits transactions with the government to commercial items, it will ensure many of the most notorious regulations remain inapplicable.

For example, the Truth in Negotiations Act (TINA) and government Cost Accounting Standards (CAS) are two of the most onerous government contracting regulations. The TINA requires vigorous disclosures of sensitive and competitive information, while the CAS generally requires conforming accounting standards to government practices. These regulations subject contractors to detailed and burdensome audits. Moreover, violations could impose multimillion-dollar fines and criminal liability. Still, each of these regulations contains exemptions

for commercial item contracts or subcontracts.[5] Additionally, neither is applicable to contracts or subcontracts under $650,000.[6]

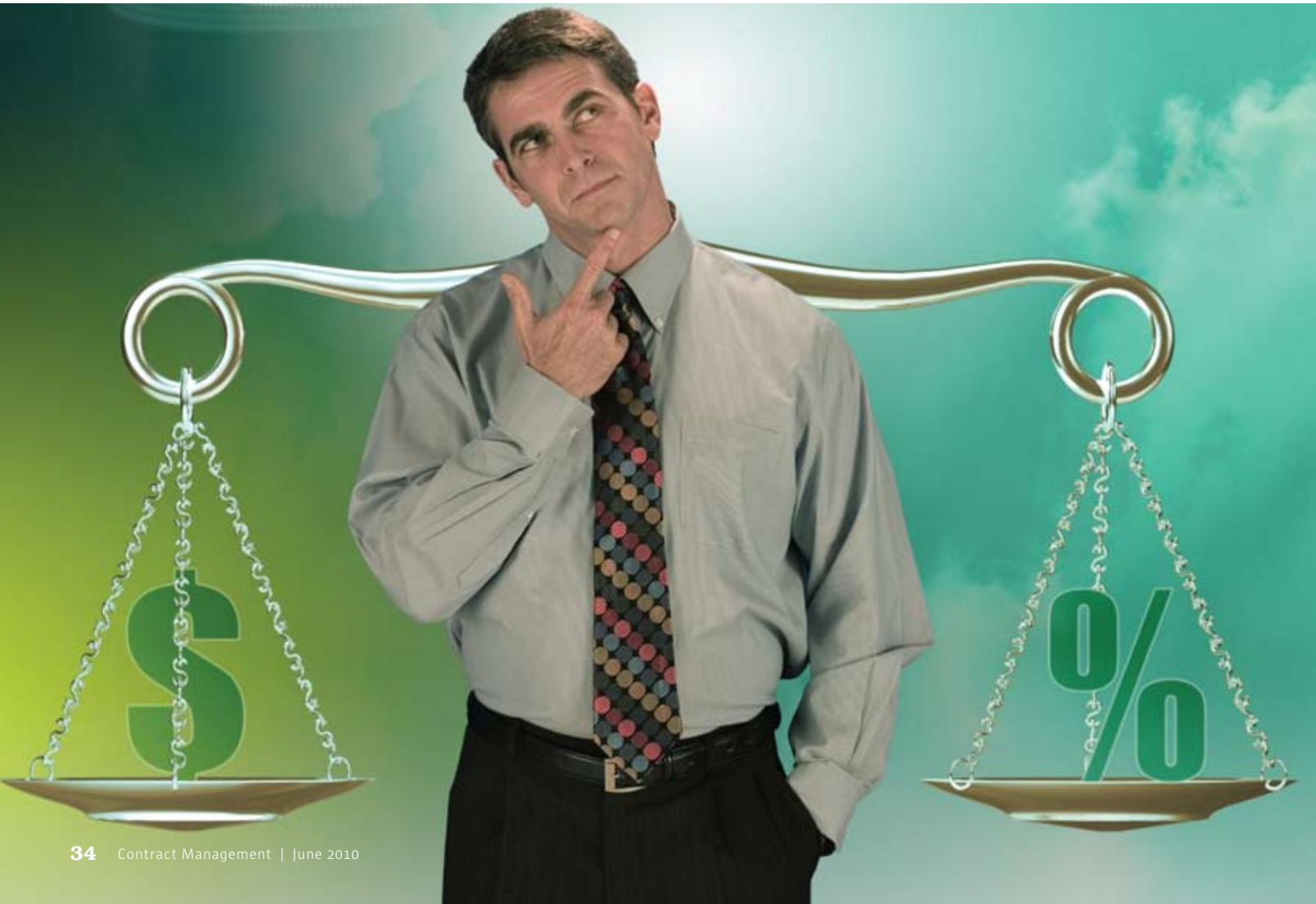
While limiting transactions with the federal government to commercial items is a significant step toward easing the burden of being a government contractor or subcontractor, there are still other compliance requirements. This article does not provide an exhaustive list of clauses, but is intended to bring attention to clauses known to drive considerable cost and administrative action.

Equal Opportunity and Affirmative Action Laws

Federal Acquisition Regulation (*FAR*) 52.222-26, "Equal Opportunity," is required in all federal contracts not deemed exempt from Executive Order 11246.[7] This clause invokes the Executive Order's requirements and places authority in the Office of Federal Contract Compliance Programs (OFCCP) to ensure compliance.

There are two significant provisions in this Executive Order. The basic provision is that if the contractor has more than $10,000 in government business in one year, it is prohibited from discriminating in employment decisions on the basis of race, color, religion, sex, or national origin.[8] This basic provision is similar to the obligations under Title VII of the Civil Rights Act of 1964. The second provision is that if the contractor has $50,000 or more of government business and employs 50 or more employees, it is required to develop and maintain an affirmative action program for each of its facilities.[9] This affirmative action provision could result in significant costs for your organization. Contract managers need to anticipate this to control the impact where possible. However, when counting heads or assessing that impact, be wary of separate divisions and even separate parent/sister entities because OFCCP will consider any entities that are sufficiently integrated to be combined.[10] This could add a costly requirement to your organization; or even worse, extend a costly requirement to divisions that are unrelated to your contract.

These requirements could have serious implications for subcontractors as well, because FAR 52.222-26 is a mandatory flowdown.[11] For example, assume we manufacture ovens at a conglomerate and our facility is already subjected to an affirmative action plan because the microwave division sells its products to the government. However, our company's new federal oven contract requires flowing down the affirmative action provisions to our burner supplier, who has never had a federal contract. Levying this new requirement on our supplier may increase the price of the burners. We may even need to find a new supplier.



It is possible to obtain an exemption from OFCCP for specific facilities unrelated to the contract; however, contract managers should not rely on this because exemptions are rarely granted. When OFCCP evaluates requests, it looks to ensure that the facilities are separate in all respects and that an exemption will not impede the effectiveness of the Executive Order.[12] There is a published policy directive that sets forth factors OFCCP will consider on each of these points.[13] If an exemption is granted, it will have a limited term of validity; moreover, OFCCP would still retain jurisdiction to investigate employee complaints.

Buy American Act

FAR 52.225-1, "Buy American Act—Supplies," provides a U.S. government preference for domestically manufactured end products. The clause is applicable to commercial item contracts. The clause generally requires that the end product be manufactured in the United States and the cost of domestically manufactured components exceeds 50 percent of the cost of all components.[14]

There are noteworthy exceptions to this clause, which include the following.

- **Public interest**—this is a rare exception where the agency head has determined a domestic source would be inconsistent with public interest.
- **Non-availability**—this exception requires the contracting officer to determine if there is an insufficient supply of quality domestic products.
- **Unreasonable cost**—this exception theoretically increases the foreign offer by a fixed percentage and if it is still lower-priced than the domestic item, the contracting officer may select it.[15]

The problem with these exceptions is that they generally require the contracting officer to make findings that are reviewed thoroughly by agency officials. Contracting officers are not likely to embrace these bureaucratic processes because they cause delay and create additional oversight into their methods and decisions.

The most likely exception for sellers of commercial items is for "commercially-available-off-the-shelf" (COTS) items. The Buy American Act treats COTS items as domestic if they were manufactured in the United States. This is a significant exception because it removes the burdensome need to track the origin and cost of individual components.[16]

A COTS item is a limited subset of the *commercial item* class defined in FAR 2.101. COTS items are commercial items offered to the government in the same form as when they are sold commercially in substantial quantities. The oven manufacturer in the example, selling the government the same ovens it sells everyone else, would be a seller of a COTS item.

One more notable exception is that the "Buy American" provisions are generally waived for end products from countries with U.S. trade agreements.[17]

To see how all of this works, let us go back to the oven manufacturer. Assuming the components are assembled at a plant in St. Louis, Missouri, it is considered to be manufactured in the United States. Additionally, the clock and burner are domestically manufactured, but the steel and thermostat are imported from China and make up 60 percent of the total cost. We do not meet the general "Buy American" provisions, but since we are selling a COTS item, the costs of the components do not matter. We comply simply because it is a COTS item and the final product is assembled in the United States.

As a contract manager, you need to know if your company's end products are covered under an exception or could be considered COTS items. If so, your government contracting burden could be greatly reduced. Alternatively, if you accept a federal contract or subcontract without verifying your status under this clause, it could require changes to your supply chain. In addition to the administrative cost of actually tracking the origins of individual components, this domestic requirement could disrupt product specifications and pricing. Moreover, your contract certifications could be at risk if you are unsure of your status under this clause.

American Recovery and Reinvestment Act (ARRA)

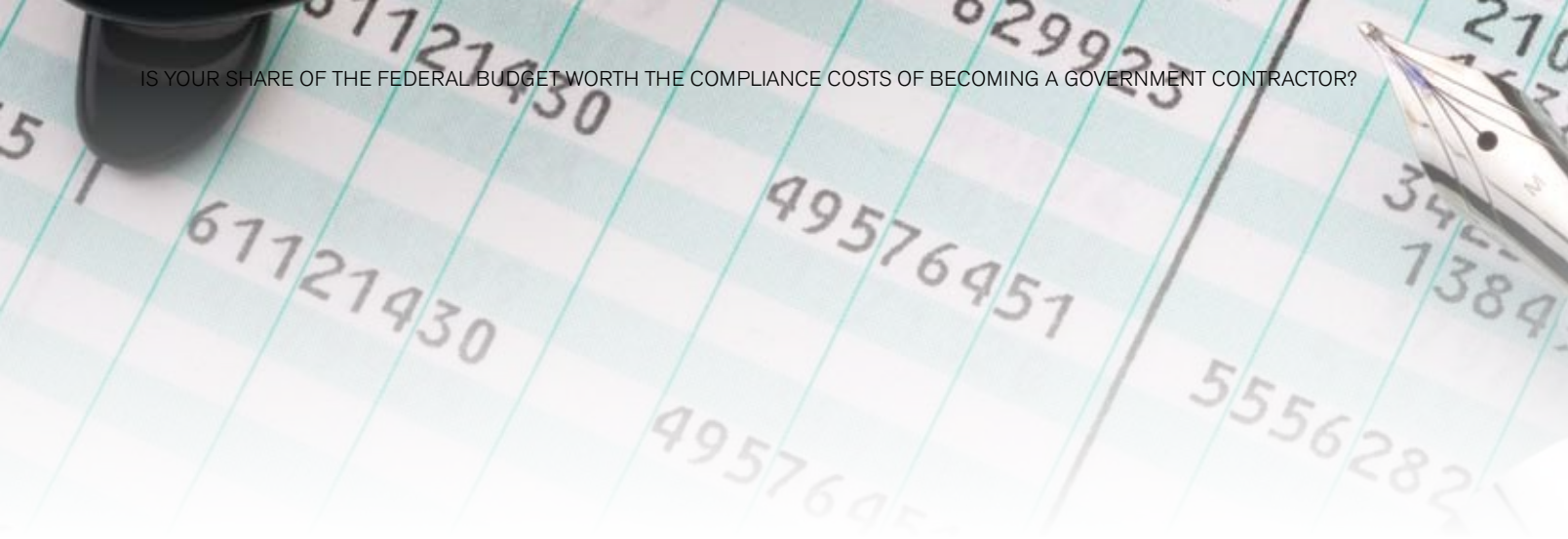
FAR 52.204-11, "American Recovery and Reinvestment Act—Reporting Requirements," is a required clause in contracts using ARRA funds.[18] This clause notably requires contractors to submit quarterly reports—to be made publicly available—that include:

- Invoicing history,
- Assessments on progress of the work,
- Narratives on employment impacts, and
- Total compensation of the five highest compensated officers.

This officer compensation reporting is only required if the contractor receives $25 million or more in annual gross revenue from federal contracts and subcontracts, which comprises 80 percent or more of the contractor's annual gross revenue, and only if senior executive compensation is not already reported periodically to the Securities and Exchange Commission.

Under FAR 52.204-11, the prime contractor is required to report detailed first-tier subcontractor information if it has subcontracts valued at $25,000 or more and the subcontractor has gross income of $300,000 or more.[19] This subcontractor reporting includes officer compensation, subject to the same $25 million and 80 percent thresholds as the prime.

The Federal Business Opportunities website flags solicitations that will use ARRA funds. As contract managers, you need to be aware if the contract you are bidding or performing on uses ARRA funds because this clause could result in additional administrative costs and intrusive public disclosures.



Service Contract Act of 1965

FAR 52.222-41, "Service Contract Act of 1965," is required in federal contracts over $2,500 if the principal purpose of the contract is to furnish services in the United States through service employees.[20] The basic requirement is to pay service employees performing work on the government contract no less than the prevailing rates and fringe benefits in that locality, as determined by the U.S. Department of Labor. This clause is a mandatory flow-down to subcontractors.[21] Violation of this clause is one of the most frequent causes of debarment of federal contractors.

Frequently, this clause increases total compensation costs and carries administrative burdens as well. Detailed records of wages, benefits, deductions, and hours must be kept for three years on every employee performing on the government contract.

Current wage determinations can be viewed online at **www.wdol.gov**. Contract managers should assess the impact of applicable wage determinations before proposing services to the federal government so that the increased compensation can be passed through to the government. For example, assume we are looking to provide childcare services under a federal contract in St. Louis County and previously paid our attendants wages ranging from $8 per hour to $12 per hour. The U.S. Department of Labor has published the prevailing wage for childcare attendants in St. Louis County at $9.61 per hour. This wage will be listed in the federal contract. We cannot allow attendants below that wage to work on this contract without giving them a raise.

If this clause does not apply to your potential government contract, your contract is likely covered under a separate wage regulation. The Davis-Bacon Act applies to federally-funded construction contracts and provides similar prevailing wage requirements.[22] The Walsh-Healey Public Contracts Act applies to government contractors furnishing goods and requires that employees be paid no less than the federal minimum wage and time-and-a-half for hours in excess of 40 per workweek. Unless your business was somehow not involved in interstate commerce under the Fair Labor Standards Act of 1938, Walsh-Healey will not significantly modify your existing wage-related requirements.

E-Verify

FAR 52.222-54, "Employment Eligibility Verification," is required in federal contracts over $100,000 where the period of performance is 120 days or more if the work will be performed within the United States.[23] The E-Verify requirement is only a mandatory flow-down to subcontracts with a value of more than $3,000, for services or construction, and performed in the United States.[24]

Note that COTS items and COTS items with "minor modifications" are exempt. *Minor modifications* is a term defined as: "modifications that do not significantly alter the nongovernmental function or essential physical characteristics of an item or component, or change the purpose of a process."[25] This assessment looks primarily at the cost of the modification in comparison to the cost of the final product.

If your company's end products are not COTS items or COTS items with minor modifications, this clause will apply. It requires the contractor to verify employment eligibility through the U.S. Department of Homeland Security E-Verify system. The eligibility check is required for all current employees performing direct work on the contract and all new hires regardless of whether they are working on the contract.[26] The impact is generally minor since the check is not required for current employees not performing direct work on the contract. As a contract manager, you need to be able to anticipate the impact of this clause on your business.

Our oven manufacturer will normally be exempt from this requirement because it sells COTS items. However, assume that the government has requested ovens made of titanium to withstand highly-destructive environments. This takes the oven out of COTS status and the modification is costly so it is not a COTS item with minor modifications. The titanium oven is still "of a type" customarily sold to the public, so it is a commercial item. E-Verify will be applicable to this contract and we will need to ensure appropriate administrative action is taken. However, we will not need to flow this down to our titanium, burner, clock, or thermostat suppliers because their subcontracts are not for services or construction.

Code of Conduct Programs

FAR 52.203-13, "Contractor Code of Business Ethics and Conduct," is required in all federal contracts expected to exceed $5 million where the period of performance is 120 days

or more.[27] It is a mandatory flow-down to subcontracts exceeding $5 million where the period of performance is 120 days or more.[28] The clause requires contractors to develop a code of ethics within 30 days after contract award and to distribute that code to all employees performing on the contract. Additionally, the clause requires contractors to disclose violations of law connected to the contract to both the contracting officer and the Office of the Inspector General in a timely manner.[29] The penalty for a failure to disclose includes being suspended or debarred from receiving federal contracts.

While commercial item contractors are required to distribute a code of ethics and disclose violations of law, they are exempt from maintaining a business ethics awareness, compliance, and internal control system under this clause.[30] Regardless, it will be difficult to detect violations without a system, so some administrative action may be necessary.

Developing a code of ethics is not necessarily a costly requirement, and most commercial businesses already maintain an internal control system as a best practice or a Sarbanes Oxley requirement. Accordingly, contract managers should understand that this clause does not usually impose burdensome requirements to commercial item contracts.

Conclusion

If contract managers can limit their federal contracts and subcontracts to commercial items, their main compliance concerns are likely to be affirmative action plans and "Buy American" provisions. COTS items will face even fewer compliance concerns. If your commercial sales are for services, you will encounter wage scrutiny from the U.S. Department of Labor. The remaining regulatory issues are not likely to be overly burdensome. Accordingly, it is possible for contract managers to enter the federal market with limited exposure to regulations if they approach federal contracts with a clear understanding of the triggers and implications of those regulations. **CM**

ABOUT THE AUTHOR

SCOTT F. LANE is an attorney in the Government Contracts group in the St. Louis office of Thompson Coburn LLP. Lane is a member of the St. Louis Gateway Chapter of NCMA. He can be reached at **slane@thompsoncoburn.com**.

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ENDNOTES

1. *Budget of the U.S. Government: Fiscal Year 2011* (February 1, 2010), *available at* **www.gpoaccess.gov/usbudget/fy11**.
2. *See, e.g.*, FA7000-10-R-0021, W9124R-10-R-0004, W912SV-10-R-0005, and W912NS-10-T-0015, *available at* **www.fbo.gov**.
3. *See* 48 Code of Federal Regulations (C.F.R.) 12.503 and 48 C.F.R. 12.504 for a list of clauses modified by commercial status.
4. 48 C.F.R. 2.101.
5. 48 C.F.R. 15.403-1 and 48 C.F.R. 9903.201-1.
6. CAS also contains noteworthy exemptions for contracts with small businesses and contracts less than $7.5 million, if the contractor is not performing any CAS contracts valued at $7.5 million or greater.
7. 48 C.F.R. 22.810(e).
8. 41 C.F.R. 60-1.4.
9. 41 C.F.R. 60-1.40.
10. A list of factors is published by the Department of Labor, Office of Federal Contract Compliance Programs, *available at* **http://www.dol.gov/ofccp/regs/compliance/faqs/emprfaqs.htm**; *see also* 52 Comp. Gen. 145, B-170536, 1972 CPD ¶ 83, WL 8798 (September 21, 1972).
11. 48 C.F.R. 52.244-6(c)(1)(iv).
12. 48 C.F.R. 22.807(b)(7).
13. U.S. Department of Labor, Office of Federal Contract Compliance Programs, "Policy Directive 260" (September 13, 2002), *available at* **www.dol.gov/ofccp/regs/compliance/directives/dir260.pdf**.
14. 48 C.F.R. 25.101.
15. 48 C.F.R. 25.103.
16. 48 C.F.R. 52.225-1 and 48 C.F.R. 12.505.
17. *See* 48 C.F.R. 52.225-5 and 48 C.F.R. 25.402.
18. 48 C.F.R. 52.212-5 and 48 C.F.R. 4.1502.
19. 48 C.F.R. 52.204-11(d)(9)–(10).
20. 41 U.S.C. 351.
21. 48 C.F.R. 52.222-41(l).
22. *See* 48 C.F.R. 52.222-6.
23. 48 C.F.R. 22.1803.
24. 48 C.F.R. 52.222-54(e).
25. 48 C.F.R. 2.101, paragraph (3)(ii) of the definition of "commercial item."
26. 48 C.F.R. 52.222-54(b)(2).
27. 48 C.F.R. 3.1004(a).
28. 48 C.F.R. 52.203-13(d).
29. 48 C.F.R. 52.203-13(b).
30. 48 C.F.R. 52.203-13(c).