

STANDARDS FOR DETERMINING WHETHER AN ITEM IS “COMMERCIAL”

Q: How do you know when an item used exclusively for military purposes is a “commercial item”?

A: When a sole source contractor tells you so.

While the answer given above may strain your credulity, a few contractors have not been embarrassed to claim that some such items fall squarely under the FAR 2.101 definition of “commercial item.” Contractors are seeking to have noncompetitive items which are normally thought of as military equipment classified as commercial items based on minimal sales to nongovernmental customers for specialized applications, on direct sales to foreign governments, or on merely offering an item for sale to the general public with little, if any, real expectation that the item will be bought by any nongovernmental customer. Their actions shouldn’t be surprising, given the stakes involved.

If the item is classified as a “commercial item” the contractor reaps several benefits. Among other things, the contractor is not required to submit cost or pricing data (FAR 15.403-1(b)(3)); the Government’s rights to in-process inspection are limited (FAR 12.208); the Government’s rights to obtain technical data which might support future competition are limited (FAR 12.211); and Cost Accounting Standards do not apply (FAR 12.214). One contractor has asserted that commercial prices can include amortization of developmental and nonrecurring costs already paid by the Government because the contractor’s “business model” used to determine prices offered to the general public includes those costs.

Although the stakes are high, detailed guidance is hard to come by. The Federal Acquisition Regulation defines “commercial item” (in pertinent part) to mean:

- (a) any item . . . that is of a type customarily used for nongovernmental purposes and that –
 - (1) Has been sold, leased, or licensed to the general public; or
 - (2) Has been offered for sale, lease, or license to the general public;
- (b) Any item that has evolved from an item described in paragraph (a) of this definition 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 Government solicitation;
- (c) Any item that would satisfy a criterion expressed in paragraphs (a) or (b) of this definition, but for –
 - (1) Modifications of a type customarily available in the commercial marketplace; or

(2) Minor modifications of a type not customarily available in the commercial marketplace made to meet Federal Government requirements. Minor modifications means modifications that do not significantly alter that nongovernmental function or essential physical characteristics of an item or component, or change the purpose of a process. Factors to be considered in determining whether a modification is minor include the value and size of the modification and the comparative value and size of the final product. Dollar values and percentages may be used as guideposts, but are not conclusive evidence that a modification is minor;

(d) Any combination of items meeting the requirements of paragraphs (a), (b), (c), or (e) of this definition that are of a type customarily combined and sold in combination to the general public;

. . .

FAR 2.101 (June 1997).

There are a number of GAO cases that have considered whether a particular product qualifies as a “commercial item,” but they offer little insight into the exact meaning of terms in the definition. *See, e.g., Coherent, Inc.*, B-270998, 96-1 CPD 214 (May 7, 1996), *Canberra Industries, Inc.*, B-271016, 96-1 CPD 269 (June 5, 1996) (both cases considered a pre-FASA DFARS clause definition of “commercial item”). What is most notable about the cases is their statement of the settled standard of review: “Determining whether a product or service is a commercial item is largely within the discretion of the contracting agency, and such a determination will not be disturbed by our Office unless it is shown to be unreasonable.” *Aalco Forwarding, Inc.*, B-277241.8, B-277241.9, 97-2 CPD 110 (Oct. 21, 1997) at 11 (citing *Canberra* and *Coherent*). A well-reasoned finding, then, that an item is or is not a FAR 2.101 commercial item will withstand GAO review. However, this begs the question of what will be considered well-reasoned.

Any decision on whether something is a commercial item will likely turn on the precise meaning assigned to such key terms as “of a type,” “customarily,” and “nongovernmental purposes.”

For the phrase “of a type” to have any meaning whatsoever, it will have to be read fairly narrowly, as a broad meaning will render the entire text meaningless: As four-legged, hay-burning equine vertebrates, both Shetland ponies and Thoroughbreds can safely be considered “of a type.” That similarity is not meaningful (or helpful) in determining whether Shetland ponies qualify as racehorses. Similarly, while it could be argued that all aircraft engines are “of a type,” this certainly does not mean that all aircraft engines are commercial. Any determination whether a particular engine is a commercial item will require a case-

by-case, fact-based inquiry; any well reasoned determination will necessarily define the meaning of “of a type” by limiting itself to factors that are meaningful in the context of the determination to be made.

In discussions over the nature of an end item, one contractor stressed that language requiring items to be “sold in substantial quantities to the general public” was eliminated in the revised definition of “commercial item” that came with FASA and its implementing regulations. With that change, the standard appeared to be loosened considerably; now merely *offering* for sale, lease, or license to the general public would satisfy that prong. The implication (and flaw) in the contractor’s position is that the change eliminated the necessity of use by the general public. That conclusion ignores the threshold language that the prong supplements: “any item . . . customarily used for nongovernmental purposes” If merely offering to sell to the general public were the whole standard for deciding whether an item was commercial, a printed catalog or web page from a legitimate defense contractor offering tactical nuclear weapons to the general public would render such weapons “commercial items” (and presumably, would also provide valuable pricing information for the contracting officer in determining a fair and reasonable price). The requirement that an item must first be “customarily used for nongovernmental purposes” prevents the definition from being ludicrously overbroad.

Without the word “customarily”, the phrase is similarly susceptible to manipulation: a single nongovernmental use would satisfy the requirement (would one appearance by a Harrier jet or an Apache helicopter in a Hollywood film make those aircraft commercial items?). Webster’s Third New International dictionary defines custom, in part, as “a usage or practice that is common to many.” The plain meaning of “customarily” in the FAR language is clear. Nongovernmental use must be far beyond isolated instances for an item to be considered commercial.

“Nongovernmental” is also a term subject to interpretation. Recent privatization efforts have altered the traditional perceptions of inherently governmental versus proprietary functions. The FAR definition recognizes that the mere fact that an item is used by the military will not prevent classification an item as commercial. No one would seriously argue that desktop personal computers, or the desk, or the paper aren’t commercial items, or that tactical nuclear weapons are.

Where an item is used *only* by the military, it’s a pretty good bet that the item is not commercial. However, there are further hurdles in the definition. It must be determined whether the item is only a “minor modification not customarily available in the commercial marketplace” or a commercially available modification away from being a “commercial item.” If an item available to the

Government but not yet in the commercial markets evolved from a commercial item, it qualifies as a FAR 2.101 commercial item.

Once the contracting officer has, in consultation with the appropriate technical personnel and subject matter experts, determined an item not to be a commercial item, the contractor may not accept the finding. Some of the reasons for this reluctance may be found at FAR 12.503, 12.504, and DFARS 212.503 and 212.504, which list laws not applicable to contracts and subcontracts for commercial items. Of particular note are those related to noncompetitive buys.

The benefits to be derived from streamlined methods of contracting for commercial items disappear when there is no competition in the marketplace. The Truth in Negotiations Act (TINA), 10 U.S.C. 2306a, has long been one of the strongest weapons in the Government's arsenal in negotiations with sole source contractors. Designed to help level the playing field, access to contractor's cost and pricing data and the ability to recover overpayment when disclosure of the data was inadequate kept some balance in the process. In a recent negotiation, one contractor insisted that the end item was commercial and refused to offer cost or pricing data. After protracted discussions, and a determination by the contracting officer that the item did not meet the FAR standards, data was submitted. The price eventually negotiated was \$26 million less than the "commercial" pricing documented by the contractor.

Even if an item technically meets the legal standard for treatment as a commercial item, the commercial demand for that item may be so small that it imposes no real restraint on the contractor's pricing, and provides no economy of scale to its production. In that event, while the contractor benefits from the classification, there is no corresponding benefit to the Government, and significant potential detriment.

Especially in sole source contracting above applicable threshold amounts, the determination of whether an item is commercial will be of great concern to both parties. It is in the interest of both the Government and the defense industry to ensure that standards are uniform throughout AMC, both to prevent "whipsawing" of contracting officers by contractors through claims of findings at other AMC commands, and to prevent inequitable and inconsistent treatment of contractors.

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