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How DOD Plans To Change Commercial Item Contracting

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Over the summer, pursuant to Section 874 of the fiscal year 2017 National Defense Authorization Act,[1] the U.S. Department of Defense issued a proposed rule[2] to exclude the application of certain laws and regulations to the acquisition of commercial items, including commercially available off-the-shelf items. Among other things, the proposed rule identifies certain Defense Federal Acquisition Regulation Supplement and Federal Acquisition Regulation clauses that should be excluded from commercial item contracts and subcontracts, and sets forth a narrower definition of "subcontract" that would carve out a category of lower-tier commercial item agreements from the reach of certain flow-down requirements. A summary of the proposed rule and our key observations and takeaways are below.

The Proposed Rule

What's In and What's Out

Numerous clauses implemented after Jan. 1, 2015, are discussed in the proposed rule, including but not limited to those relating to cybersecurity, cloud computing, paid sick leave, taxes, counterfeit parts, taxes, 8(a) competitions, and past performance information. The DOD's assessment of the applicability of these clauses to commercial item contracts, and the acquisition of COTS items, is set forth in this chart.

Redefining "Subcontract" to Limit Flow-Downs

The proposed rule would implement a new uniform definition of "subcontract" in the DFARS for the purpose of determining what is, and is not, a commercial item subcontract:

Subcontract means any contract, as defined in FAR subpart 2.1, entered into by a subcontractor to furnish supplies or services for performance of a prime contract or a subcontract. The term—

(1) Includes a transfer of commercial items between divisions, subsidiaries, or affiliates of a contractors or subcontractor; and

(2) Does not include agreements entered into by a contractor for the supply of commodities that are intended for use in the performance of multiple contracts with the Department of Defense and other parties and are not identifiable to any particular contract.

This definition would be added to DFARS 212.001 (Definitions under Acquisition of Commercial Items), DFARS 252.244-7000 (Subcontracts for Commercial Items) and "each DFARS clause that requires flowdown to subcontracts for the acquisition of commercial items, with specified applicability to the flowdown paragraph of the clause."

As reflected in the language emphasized above, in general the stated purpose of this new definition is to "clearly exclude [the] flowdown [of clauses] to supplier agreements that are not identifiable to any particular contract."

Reconfirming That the Counterfeit Parts Flow-Down Requirements Apply to All Contractual Instruments

Despite the new definition of "subcontract," the proposed rule explains that "any contractual instrument that could be used to acquire electronic parts" still must include the obligations and protections provided in DFARS 252.246-7007 (Contractor Counterfeit Electronic Part Detection and Avoidance System) and DFARS 252.246-7008 (Sources of Electronic Parts). This is because electronic commodity parts are used in fielded weapon systems and "[e]xempting acquisitions" from these requirements "would create unacceptable risks" to the supply chain and ultimately can "endanger troops' lives."

Accordingly, these two DFARS clauses would be further amended to require that the obligations and requirements in these clauses "flow down to all levels of the supply chain without exception for any contractual instrument that could be used to acquire electronic parts."

Prohibiting Prime Contractors From Incorporating Certain Clauses in Commercial Item Subcontracts

In an apparent attempt to curtail the practice of flowing-down an overabundance of nonmandatory clauses to commercial item subcontractors, the proposed rule explains that contractors "will be prohibited from flowing-down FAR or DFARS clauses to commercial items, unless flow down is specifically required in the FAR or DFARS." Instead, "any discretion to impose flowdown of clauses that are not based on statute or Executive order shall rest with the Government, not with the contractors."

Reconfirming the Applicability of the Limitations in FAR Part 12

Recognizing that "the DFARS supplements the FAR," the proposed rule explains that the requirements in FAR part 12 apply to DOD acquisitions. First, the proposed rule re-confirms that the requirements in FAR 12.301(a) also apply to DOD commercial item contracts. FAR 12.301(a) mandates that commercial item contracts "shall, to the maximum extent practicable, include only those clauses — (1) Required to implement provisions of law or executive orders applicable to the acquisition of commercial items; or (2) Determined to be consistent with customary commercial practice." Second, the proposed rule reconfirms that the statutes listed at FAR 12.503 through 505 are inapplicable to the DOD's commercial item and COTS acquisitions and to commercial item subcontracts.

Key Takeaways and Observations

Will these new requirements apply to existing agreements?

Many commercial item contractors and subcontractors will welcome the stated premise of the proposed rule — less government contracting requirements for commercial items — and likely will want to modify their existing agreements. However, the proposed rule and Section 874 of the FY 2017 NDAA do not specifically discuss the rule's applicability to existing agreements. Thus, it is unclear what the DOD's position will be and whether contracting officers will be willing to modify existing agreements.

Will contractors actually stop flowing-down clauses to commercial item agreements?

As stated in the proposed rule, contractors "will be prohibited from flowing-down FAR or DFARS clauses to commercial items, unless flow down is specifically required in the FAR or DFARS." At first glance, this statement appears to impose significant limitations on higher-tier contractors. However, the proposed rule also recognizes that a "contractor can, of course, still impose its own requirements on subcontractors, but cannot just flow down FAR and DFARS clauses as a whole."

Thus, it appears that a higher-tier contractor will still be able to incorporate the underlying obligations of a clause, albeit with careful drafting that could require significant revisions to existing agreement templates. On the flip side, the ability of a lower-tier contractor to exclude requirements stemming from a nonmandatory clause will still depend on the underlying regulatory requirements of a higher-tier contractor and each party's bargaining power, risk profile, and overall understanding of the clause. And, it is unclear what the ramifications will be if a clause is improperly flowed-down.

What are "commodities" under the new definition of "subcontract"?

As mentioned above, the proposed rule would amend the DFARS to implement a new uniform definition of "subcontract" for commercial items that would exclude "agreements entered into by a contractor for the supply of commodities that are intended for use in the performance of multiple contracts with the Department of Defense and other parties and are not identifiable to any particular contract." Thus, this category of commercial item agreements would no longer be subject to the mandatory flow-downs applicable to commercial item "subcontracts."

What remains unresolved, however, is the definition of "commodities." Neither the proposed rule nor the FAR/DFARS include a general definition for the term "commodities" — even though the scope and impact of the definition of "subcontract" hinges on the meaning of that term.

The Section 809 Panel — an independent advisory panel on streamlining DOD acquisition regulations — explained in its January 2018 report that it reviewed this issue when assessing Section 874 of the FY 2017 NDAA.[3] The Section 809 Panel noted that it "was unable to identify an established DoD definition of the term but did identify the DoD standard definition of the term commodity loading, an indication of how the term might be defined: commodity loading — A method of loading in which various types of cargoes are loaded together, such as ammunition, rations, or boxed vehicles, in order that each commodity can be discharged without disturbing the others." The Section 809 Panel also commented that the "standard dictionary definition provides an alternative, narrower approach, defining a commodity as 'a mass-produced unspecialized product: commodity chemicals, commodity memory chips.'"

Although we were able to identify some instances where the term "commodities" is used in the DFARS, these definitions, like the definitions identified by the Section 809 panel, provide only limited guidance. First, "commodities" is defined at DFARS 229.170-1, under Part 229 (Taxes), as "any materials, articles, supplies, goods, or equipment." Because this definition is so broad it may not be readily useable. Second, DFARS 252.225-7012, which implements the Berry Amendment, is titled "Preference for Certain Domestic Commodities," and identifies items like food, clothing, cotton, woven silk and canvas products. This de facto definition is fairly narrow and likely would exclude items that DOD officials and contracting officers would deem to be "commodities."

In any event, the new definition of "subcontract" will depend heavily, if not entirely, on the definition of the term "commodities," and we are hopeful that the DOD will provide some clarification upon issuing its final rule.

DOD revisions to the flow-down requirements in the cybersecurity area may present challenges.

The DOD's suggested flow-down language for DFARS 252.204-7012 (Safeguarding Covered Defense Information and Cyber Incident Reporting) may present challenges for contractors. Most notably, the proposed language clarifies that the flow-down requirement does not apply to a COTS item:

Include this clause, including this paragraph (m), without alteration except to identify the parties, in subcontracts, or similar contractual instruments, for operationally critical support, or for which subcontract performance will involve covered defense information, including subcontracts for commercial items, except subcontracts for commercially available off-the-shelf items.

However, in that same subsection, the DOD retains the requirement for higher-tier contractors to determine if subcontract performance involves covered defense information and if the protections under the clause are required.

Given that the DOD's April 2018 FAQs on the DFARS clause notes that "[p]rocurements solely for the acquisition of COTS items are extremely unlikely to involve" covered defense information, it appears that the DOD intends to exclude COTS procurements. However, the language in the next sentence of the clause requiring a higher-tier contractor to determine whether any CDI is being shared creates some uncertainty. Specifically, if a higher-tier contractor determines that CDI must be provided under a COTS subcontract, must it then flow-down the clause? Is that higher-tier contractor even required to make the assessment if a COTS item is at issue? Moving the language to two separate paragraphs would provide clarity to contractors.

Finally, although DFARS 252.204-7012 incorporates the new definition of "subcontract," the flow-down requirement for this clause appears to sidestep the new definition by requiring contractors to flow-down the clause to "subcontracts, or similar contractual instruments, for operationally critical support, or for which subcontract performance will involve covered defense information." However, this language becomes less clear when you compare it to the counterfeit part clauses that require certain requirements to be flowed-down to "subcontracts and other contractual instruments, including subcontracts and other contractual instruments for commercial items." Is there a difference between similar contractual instruments and other contractual instruments?

Will the DOD's assessment of future provisions of law and contract clauses help to streamline commercial item and COTS acquisitions?

Presumably, the DOD will assess the applicability of future statutes and clauses to commercial item (or COTS) prime contracts and subcontracts in the same manner that it has conducted its assessment under the proposed rule. 10 U.S.C. § 2375, as amended by Section 874 of the FY 2017 NDAA, offers some guideposts about how the DOD would make this assessment.

Specifically, 10 U.S.C. § 2375 states that, subject to certain exceptions, a law or clause that the DOD "determines sets forth policies, procedures, requirements, or restrictions for the procurement of property or services by the Federal Government" will not apply to commercial item (or COTS) prime contracts and subcontracts unless the DOD determines that this "would not be in the best interest of the Department of Defense." The stated exceptions include provisions of law or contract clauses that: (1) provide for "civil or criminal penalties"; (2) require that "certain articles be bought from American sources" under 10 U.S.C. § 2533a (the Berry Amendment); (3) require "strategic materials critical to national security be bought from American sources" under to 10 U.S.C. § 2533b (Restrictions on Specialty Metals); or (4) specifically state that the provision of law or contract clause shall apply.

Thus, 10 U.S.C. § 2375 appears to create a general presumption in favor of not applying a new provision of law or contract clause to commercial item (or COTS) prime contracts and subcontracts.[4] This presumption should help to streamline future commercial item procurements and ease potential barriers to entry.

Are there any other related changes on the horizon?

The short answer is yes. Section 820 of the FY 2018 NDAA (Dec. 12, 2017) also amended the definition of "subcontract" under 41 U.S.C. § 1906, which happens to provide the framework for determining whether a provision of law is inapplicable to a commercial item contract or subcontract under the FAR.

Like the definition provided in the proposed rule, Section 820 of the FY 2018 NDAA excludes any "agreements entered into by a contractor for the supply of commodities that are intended for use in the performance of multiple contracts with the Federal Government and other parties and are not identifiable to any particular contract." Thus, in due time, the FAR also will be amended to limit certain commercial item flow-down requirements to this category of agreements.[5]

What is the deadline for submitting comments, and when will the DOD issue the final rule?

Although the DOD specifically solicited comments on a variety of topics, including whether the FAR/DFARS provisions discussed above should or should not apply to commercial items and COTS items, the DOD will accept comments on any topic related to the proposed rule. As a result, contractors should not be surprised if the DOD modifies this proposed rule before issuing the final rule. The current deadline for submitting comments is Oct. 28, 2018.

As a result, it is not clear when the final rule will be issued. However, it is possible that the final rule may not be issued for quite some time. As observed in the House Armed Services Committee Report to the FY 2019 NDAA, "there has been a significant delay between statutory enactment and issuance of regulations in the Defense Federal Acquisition Regulation Supplement." And as recognized by the House

Armed Services Committee, these types of delays often place the contractors and the DOD in limbo as "the acquisition and contracting communities within and outside the Federal Government are unable to take full advantage of recent reforms and improvements to acquisition and contracting procedures."

In this instance, Section 874 of the FY 2017 NDAA, which provides the blueprint for the DOD's proposed rule, became law in December 2016 during the Obama administration — approximately 18 months before the proposed rule was issued in June 2018. Stay tuned.

Correction: A previous version of this article misspelled author Alexis Dyschkant's last name. The error has been corrected.

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[1] Section 874 of the FY 2017 NDAA amended 10 U.S.C. § 2375.

[2] Defense Federal Acquisition Regulation Supplement: Inapplicability of Certain Laws and Regulations to Commercial Items (DFARS Case 2017-D010), 83 Fed. Reg. 30646 (proposed June 29, 2018), available at https://www.federalregister.gov/documents/2018/06/29/2018-14043/defense-federal-acquisition-regulation-supplement-inapplicability-of-certain-laws-and-regulations-to.

[3] Section 809 Panel, Report of the Advisory Panel on Streamlining and Codifying Acquisition Regulations, Vol. 1 (Jan. 2018), available at https://section809panel.org/wp-content/uploads/2018/01/Sec809Panel_Vol1-Report_Jan18_FINAL.pdf.

[4] This framework is very similar to the framework already provided in 41 U.S.C. § 1906 for determining which laws are inapplicable to commercial item contracts and subcontracts under the FAR.

[5] And to make matters more confusing, pursuant to Section 836 of the FY 2019 NDAA, commercial items will be split into two categories: a "commercial product" or a "commercial service." Thus, contractors should expect to see conforming amendments to the language in the proposed rule at some point in the future.