Meeting the Recovery Act's Buy American Standards: US and Foreign Firms Face Complicated Regulatory Guidelines

The Executive Branch recently issued its interim rules implementing the Buy American restrictions of the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"). On April 3, 2009, the Federal Acquisition Regulation (FAR) Council issued regulations covering direct federal contracts, 74 Fed. Reg. 14621 (Apr. 3, 2009), and on April 23, 2009, the Office of Management and Budget (OMB) regulations covering grants, cooperative agreements and loans for state and local procurements appeared in the Federal Register, 74 Fed. Reg. 18449 (Apr. 23, 2009).

Section 1605(a) of the Recovery Act directs that, subject to certain exceptions, no funds appropriated or otherwise made available for a project may be used for the construction, alteration or repair of a public building or public work unless all the iron, steel and manufactured goods used are produced in the United States. The law covers Recovery Act-funded federal contracts as well as Recovery Act-funded state and local public works projects.

The law also provides for three exceptions to the Buy American[1] restriction where:

- Iron, steel or manufactured goods are not produced in the United States in sufficient and reasonably available quantities and of satisfactory quality;
- Inclusion of iron, steel or manufactured goods produced in the United States will increase the cost of the project by more than 25 percent;
- Applying the Buy American restriction is inconsistent with the public interest.

In reality, these exceptions will likely rarely, if ever, be used. However, in response to concerns expressed by US trading partners, Congress further provided that the Buy American restriction "shall be applied in a manner consistent with the United States obligations under international agreements." *See* Recovery Act § 1605(d). This provision essentially means that, despite the Buy American restriction, iron, steel and manufactured goods from World Trade Organization Government Procurement Agreement (WTO GPA) countries and Free Trade Agreement (FTA) countries will not be discriminated against in projects using the Recovery Act funding. Additionally, the Recovery Act's legislative history includes a statement that "least developed countries" should be eligible to participate in stimulus projects.

New Regulations Address Federal Contracts

A new FAR subpart 25.6, "American Recovery and Reinvestment Act—Buy American Act—Construction Materials," applies to federal construction projects using Recovery Act funding. Although these Buy American regulations represent, in large part, a regulatory *status quo*, as discussed further below, there are anomalies in the new rules. Consistent with obligations under current trade agreements, the new FAR rule provides that for construction projects exceeding $7.443 million, in addition to domestic end products, products from WTO GPA countries, FTA countries and least developed countries are acceptable (Caribbean Basin Trade countries are not included).

Under the FAR rule, in order for domestic iron and steel to be considered "produced in the United States" all manufacturing processes (e.g., melting and pouring, rolling, bending and shaping), with the exception of the metallurgical processes for steel additives, must

be performed in the United States. In contrast, for WTO GPA, FTA and least developed countries, the FAR applies the "substantial transformation" test to determine country of origin. "Substantial transformation" is a different standard than the "produced in the United States" test as it does not require that all manufacturing processes be performed in an eligible country. Rather, "substantial transformation" requires that the product be transformed in an eligible 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."

These differing country-of-origin rules ("complete" domestic manufacture versus foreign substantial transformation) apply to iron and steel used as a construction material (e.g., beam, rebar, girders) for a public building or public work. As a result, whether intentionally or not, the regulations have a perverse consequence for the treatment of iron and steel. For example, a federal contractor could provide an iron or steel construction material that was originally poured in Brazil, China or India and subsequently substantially transformed in France, the United Kingdom or any other eligible country but could not provide the same product if it were substantially transformed in the United States.

Ironically, this distinction likely will make it more difficult for some domestic suppliers to compete with suppliers from WTO GPA, FTA or least developed countries. Domestic suppliers that import iron or steel and then substantially transform it into a final, deliverable construction material for direct federal procurements will have to pay close attention to the government's application of this rule. Further, as the FAR Council issued the regulations as an interim rule seeking public comments, there is an opportunity for clarification of the rule.

With regard to manufactured goods, the FAR focuses on the place of "manufacture" or "substantial transformation" of an end product. The FAR uses the same "substantial transformation" test for WTO GPA, FTA and least developed country manufactured goods. To be considered of domestic origin, a good must be manufactured in the United States. There is no restriction on the country of origin of components or subcomponents (including iron and steel used in components or subcomponents) nor is there any requirement for a minimum proportion of domestic components. However, there is no definition of "manufactured" in the regulations. Given this lack of a definition for purposes of domestic manufactured goods, the lack of any restrictions or requirements regarding the origin of components and subcomponents in manufactured goods, and the explicit use of "substantial transformation" for other than domestic manufactured goods, it is likely that "manufactured" will be interpreted as meaning "substantial transformation" for purposes of determining domestic manufactured goods.

The FAR rule also implements the criteria and procedures for seeking any of the three statutory exceptions from application of the Buy American restrictions.

New Regulations Address Federal Grants and State/Local Procurements

OMB's interim regulations address grants, cooperative agreements and loans (the "grant regulations"). *See* 2 CFR § 176.[2] Although the grant regulations cover cooperative agreements and loans, federal grants will likely be the chief tool for distributing Recovery Act funding related to state and local procurements. Federal grants can be awarded directly to private entities but are more typically provided to states or local quasi-governmental entities that in turn use the federal grants for public works projects.

Under the interim grant regulations, state/local acquisitions using Recovery Act funding are treated in some respects similarly to, and in some respects differently from, federal contracts under FAR Part 25.6. The same $7.443 million threshold applies in determining the applicability of trade agreements to state procurements using Recovery Act funding. The new grant regulations include "award terms" (i.e., contract clauses) implementing the Buy American provisions. State and local governments will flow down the Buy American restrictions in Recovery Act-funded state and local contracts/grants.

The award terms define a public work/public building as a work of a governmental entity and may include,

without limitation, bridges, dams, plants, parkways, streets, subways, tunnels, sewers, mains, power lines, pumping stations, heavy generators, railways, airports, terminals, docks, piers, wharves, ways, lighthouses, buoys, jetties, breakwaters, levees, and canals, and the construction and maintenance of such works and buildings. *See generally* 2 CFR §§ 176.140-170.

The grant regulations provide that, if the estimated value of a state public work exceeds $7.443 million *and* the state/local entity is covered by a trade agreement or agreements, then domestic and/or trade agreement country iron, steel and manufactured goods may be provided under the resulting contract. Thus, unlike the FAR standard, the grant regulations provide that products from countries subject to the specified trade agreements do not automatically qualify for equivalent treatment: only if the products from those countries are subject to trade agreement concessions specific to the procuring state or local agency do the products qualify. Also, unlike the FAR implementation, the applicable "award terms" appear to provide that the "substantial transformation" test applies to domestic iron, steel and manufactured goods as well as iron, steel and manufactured goods from WTO GPA, FTA and least developed countries. *See* 2 CFR § 176.160.[2] As part of the guidance, OMB included an Appendix listing the states and other governmental entities and the corresponding trade agreements that apply to their purchases.

For example, if the state of California were to award contracts/grants using Recovery Act funds for the development of a public work with an estimated value exceeding $7.443 million, since procurement by California is covered by the WTO GPA (except Canada), iron, steel and manufactured products from any WTO GPA country other than Canada (e.g., France, Germany, Japan, Netherlands, United Kingdom) would be acceptable under the state contract/grant. It is important to note, as the Appendix indicates, many states have exceptions to the trade agreements depending upon the items to be purchased or the state sub-entity making the purchase. In particular, NAFTA (Canada and Mexico) does not apply to most states and entities listed in the Appendix. A review of the award terms contained in any state and local solicitation documents will be required to determine the extent of any Buy American restrictions and the corresponding applicability of any trade agreements.

Finally, under the grant regulations, the head of the federal department or agency providing the grant has the authority to make determinations whether one of the exceptions (nonavailability, unreasonable cost, inconsistency with the public interest) applies to a specific procurement or category of procurements.[3] State/local officials cannot make such a determination. For example, if the Department of Energy provided grant funding to the state of Minnesota for a public work, Minnesota and/or a potential sub-recipient of the funding would have to seek an exception determination from the Department of Energy. The award terms provide the mechanics and timing for seeking an exception determination. *See* 2 CFR §§ 176.140-170.

In sum, the complexity, inconsistencies, and ambiguities of the new regulations promise to create challenges for both the public and private sector in interpreting and applying the rules to the many projects that will receive Recovery Act funding. Yet compliance with the applicable Buy American standards will be critical to firms participating in any Recovery Act-funded project, because failure to comply may subject the violator to severe consequences, including contract or project termination, False Claims Act liability, suspension, and/or debarment. For businesses participating in Recovery Act projects, developing and implementing robust compliance plans will be vital to ensuring successful performance.

Endnotes

[1] Apart from the Recovery Act, the current statutory scheme distinguishes between the Buy American Act, 41 U.S.C. § 10a-10d, which applies to federal contracts, and the Buy America Act, which applies to federally funded state/local highway projects, 23 U.S.C. § 313, as well as mass transit projects, 49 U.S.C. § 5323(j), and airport projects, 49 U.S.C. § 50101. The Recovery Act and the implementing regulations do not make this distinction and instead use the term "Buy American" with respect to all Recovery Act-funded projects.

[2] There is an inconsistency in the grant regulations. The "award terms" applicable to projects exceeding $7.443 million indicate that the "substantial transformation" applies to domestic iron and steel. However, 2 CFR § 176.70, like the FAR, provides that for iron and steel "all manufacturing processes must take place in the United States, except for metallurgical processes involving refinement of steel additives."

[3] For example, on April 7, the Environmental Protection Agency issued a waiver of the Buy American restrictions for Recovery Act-funded projects with debt incurred on or after October 1, 2008, that are refinanced through the clean or drinking water state revolving funds. *See* 74 Fed. Reg. 15722 (Apr. 7, 2009).

For more information about the new regulations, the Buy American restrictions, or any other matter raised in this Client Update, please contact your regular Mayer Brown lawyer or one of the following lawyers.

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