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FEATURE COMMENT: GAO And COFC Reach Opposite Conclusions In Determining Product Origin Under The TAA

The U.S. Court of Federal Claims and the U.S. Comptroller General have reached dramatically different conclusions on the determination of a product's country of origin under the Trade Agreements Act (TAA), 19 USCA § 2501 et seq. Compare *Klinge Corp.,* Comp. Gen. Dec. B-309930.2, 2008 CPD ¶ 102, with *Klinge Corp. v. U.S.,* No. 08-134C (Fed. Cl. June 10, 2008). These two decisions highlight important principles on the substantive rule of origin, agency procedure for determining origin in the first instance, and standards for administrative or judicial review after contract award.

Determination of Country of Origin under the TAA—Most federal procurements of goods are subject to the TAA, which requires that the end product be a product of the U.S. or a "designated country." Designated countries include members of the World Trade Organization's Government Procurement Agreement—a plurilateral agreement providing for mutual equal treatment of products of the member countries—as well as other nations that have entered similar bilateral commitments with the U.S. in free trade agreements and certain least-developed countries.

If an article has undergone manufacture or processing in multiple countries, its "country of origin" for purposes of the TAA, origin marking and certain other requirements is determined by assessing whether a "substantial transformation" occurred as a result of the processing. U.S. Customs and Border Protection (Customs) is most often called on to make such determinations. If components from various countries are assembled into completed products, Customs considers the "totality of the circumstances" and makes determinations on a case-by-case basis. See HQ 563012 (May 4, 2004) ("Fabric Switches" for "SANs") and HQ 968000 of Feb. 14, 2006. For a substantial transformation to occur, the processing of the product must cause it to emerge with a new "name, character or use." See *U.S. v. Gibson-Thomsen Co., Inc.,* 27 C.C.P.A. 267 (1940). Further, the assembly process does not constitute a substantial transformation unless the operation is "complex and meaningful." CSD 85-25 (1985). In assessing whether substantial transformation has occurred when parts or materials from different countries are combined, the determinative issues are the extent of operations performed and whether the parts lose their identity and become an integral part of the new article. See *Belcrest Linens v. U.S.*, 573 F. Supp. 1149 (Ct. Int'l Trade 1983), aff'd, 741 F.2d 1368 (Fed. Cir. 1984).

The Large Field Refrigeration System Procurement—The *Klinge* dispute arose in a Marine Corps procurement of large field refrigeration systems (LFRSs), which are refrigerated shipping containers with some special features, used by deployed troops to preserve food and medical supplies in such places as Iraq and Afghanistan. Offerors were required to certify TAA compliance. When the Corps made its initial award to Sea Box, Klinge protested to the Government Accountability Office on the ground that the Sea Box LFRS was a product of China and thus failed to satisfy the TAA requirement.

Agencies may generally rely on offerors' TAA certifications and are not required to investigate the factual basis for those representations. In response to the initial protest, the Corps prudently decided to withdraw the award, reopen the competition and require all offerors to "specifically identify the country of origin for each line item number and ... address ... compliance with DFARS 252.225-7021 (Trade Agreements)." GAO dismissed the protest

as academic. *Klinge Corp.*, Comp. Gen. Dec. B-309930, Aug. 27, 2007. Offerors, including Sea Box, included in their final proposals a work breakdown structure identifying components, describing their respective manufacturing processes and identifying the locations where each step would be performed.

It appears from the redacted GAO decision that the main components of an LFRS are the insulated steel container and the refrigeration unit. For the Sea Box LFRS, the refrigeration unit was manufactured in Singapore, a designated country, and the container was manufactured in China, an ineligible source, although China is currently in a lengthy negotiation to join the WTO GPA. At the Chinese factory, the refrigeration unit was mounted on an end panel and integrated, the end panel was bolted to the remainder of the unit, and the LFRS was tested. The Sea Box proposal referred to the Chinese operations as including a designated country, and the container was "Final Assembly." Thereafter, the unit was shipped to the U.S. According to Sea Box's work breakdown structure, Sea Box performed at the U.S. plant "all additional and necessary manufacturing processes (*e.g.*, electrical, CARC ... painting, finishing) and parts integration as well as quality assurance testing and preparation for inspection and final shipment to the government."

Except for the references to painting, finishing, inspection and testing—operations generally held *not* to amount to substantial transformation of equipment constructed in another country—the opinion does not indicate what those "necessary" integration steps entailed and what additional fittings may have been added in the U.S. There might have been much further detail in the proposal, but if there was, it is curious that none of it is cited in the opinion. It appears from the later COFC opinion that additional equipment added in the U.S. was minor, as the only items deemed worthy of mention were an interior light and transformer.

Sea Box indicated the proportions of total cost accounted for by (1) U.S. operations, (2) Chinese manufacture of the container and assembly, and (3) manufacture of the refrigeration unit in Singapore. Unfortunately, the percentages are redacted from the opinion. Whatever they were, the agency concluded that the U.S. cost was "significant," but did not claim it was larger than the other cost elements.

The Corps concluded that the Sea Box LFRS was a U.S.-made product, as claimed by Sea Box. It based this conclusion on the findings that the U.S. processes were "significant," both based on cost and effort, and that the product was not a fully functioning LFRS until the U.S. steps had been performed. The Corps again awarded to Sea Box, and Klinge protested to GAO.

GAO Decision—GAO upheld the Corps' conclusion as "reasonable," relying on the information available at the time of contract award. As is the case for most protest issues, GAO does not make a de novo determination of origin, but accepts the agency's conclusion if it has factual support and falls within a range of reasonableness. GAO found adequate support for the conclusion of U.S. origin primarily because (a) the U.S. manufacturing operations were "significant" in cost and effort, and (b) the two main components were merely bolted together in China and did not become a "functioning refrigerated container system" until additional U.S. steps were performed.

Significance of U.S. Cost and Effort: As to the significance of U.S. cost and effort, GAO appears to have applied an absolute rather than a relative standard, looking at the final steps conducted in the U.S. in isolation, and giving little or no weight to their significance compared to the operations performed during the immediately preceding stage in China. Although there are no quantitative data on labor hours or costs in the redacted opinion, it appears from the manufacturing plan description that a more comparative approach likely would have added weight to the Chinese side of the scale.

In assessing the significance of U.S. operations, GAO drew no explicit distinction between "finishing" steps and more transformative operations. The U.S. operations cited by Sea Box appear to comprise mainly "finishing" activities (painting, finishing, testing, inspection) of the kind that Customs usually holds not to constitute substantial transformation. Customs has drawn distinctions based on the kind and amount of further processing performed, i.e., between machining operations performed to achieve a specified form and those performed to achieve more cosmetic or minor processing operations. In HQ 559366 (Customs, Aug. 29, 1995), Customs reviewed the country-of-origin marking requirements for an "ulu" knife that consisted of a semicircular blade and a handle, and was used for culinary and cutlery purposes. Customs ruled that the imported blade was not substantially transformed by etching and assembly operations performed after importation into the U.S. Customs reaffirmed its

long-standing view that "embellishment and finishing operations, such as polishing, enameling and cleaning, are not regarded as extensive processes that result in a new and different article of commerce." See HQ H004649 (Customs, March 20, 2007). Similarly, in HQ 734062 (Customs, April 22, 1991), Customs ruled that cutting teeth into imported key blanks from Mexico was a minor finishing process that did not alter the keys' basic character. Other rulings have held that further processing operations, including grinding, polishing, nickel-plating, heat-treating and assembly, are finishing operations that did not effect a substantial transformation. See, e.g., HQ 733565 (Customs, Sept. 11, 1990); HQ 553197 (Customs, Feb. 11, 1985); HQ 722066 (Customs, Aug. 3, 1983).

With respect to product testing, Customs has found that merchandise machined, finished and assembled abroad and merely tested in the U.S. for conformity with U.S. standards requirements does not undergo a substantial transformation in the U.S. See HQ 732844 (Customs, Feb. 12, 1990). Nor does "inspection, testing, repair and repackaging" effect a substantial transformation. See HQ 557796 (Customs, June 3, 1994). However, Customs has also found that, if "testing and adjustments performed in Japan are technical and complex," and other processing also occurs in Japan, such processes constitute a substantial transformation. See HQ W563491 (Customs, Feb. 8, 2007).

Becoming a "Functioning System": The phrase "functioning refrigerated container system" might be read to require that 100 percent of the mandatory specifications are satisfied. But compliance with all specifications cannot be the benchmark for substantial transformation. If it were, the last place of work at which a specified feature is completed would always determine the country of origin, no matter how small its contribution to the whole. For example, the LFRS specifications presumably required an interior light fixture, but if installation of a light were the *only* step after arrival of an otherwise-complete LFRS in the U.S., that certainly would not be enough to confer U.S. origin on the final product. Instead, by "fully functional," GAO presumably meant that the LFRS was for the first time able to perform its defining functions—storage and refrigeration of its contents—after substantial transformative steps performed in the U.S.

Interestingly, GAO was only able to reach the conclusion that the LFRS became functional for the first time in the U.S. by disregarding evidence that the prototype LFRS had undergone and passed International Standards Organization (ISO) testing in China before any of the U.S. operations were performed. In a lengthy footnote, GAO concluded that this "new argument" was untimely. GAO rules have long required that new *grounds* of protest cannot be raised more than 10 days after their basis is revealed. But the point about testing was just an additional factual inference urged in support of the *original* protest ground that the Sea Box product was of Chinese origin. Although this factual inference could have been asserted in Klinge's initial response 10 days after the agency submitted its report and produced documents (including the Sea Box proposal), Klinge did not make it until more than a month later, after the agency had filed its last pleading. The key for GAO was that this argument was sufficiently distinct from the protester's other arguments that the agency and awardee were entitled to an opportunity to reply, which was hampered by the late filing. *Planning and Dev. Collaborative Int'l,* Comp. Gen. Dec. B-299041, 2007 CPD ¶ 28 at 11; *Biospherics, Inc.*, Comp. Gen. Dec. B-285065, 2000 CPD ¶ 118 at 12–13.

This procedural ruling can be viewed as going a step further than the cases cited in support. Initially, in *Planning and Dev. Collaborative Int'l,* the protester generally alleged unequal evaluation. Specific, discrete instances of unequal treatment that were raised belatedly (of which each could be viewed as a separate error) were untimely. In *Biospherics*, the protester simply failed to provide any substantive support for its protest ground until very late in the proceeding. The failure to point out this factual inference earlier may well have been decisive as to the outcome. This underscores the need for a protester to identify and present not only all protest grounds and legal propositions, but all material factual inferences in its initial comments on the agency record.

COFC Decision—Having failed at GAO, Klinge filed a protest action at the COFC on the same basis. Although the COFC has a different jurisdictional foundation and standard of review than GAO, it also accords an agency a significant range in which it can exercise reasonable judgment. Under the standard borrowed from the Administrative Procedure Act, 28 USCA § 706(2)(A), the COFC will overturn an agency action only if it is arbitrary, capricious or not in accordance with law. However, looking at essentially the

same facts, the COFC found arbitrariness where GAO saw reasonable conclusions. The COFC found that the Sea Box LFRS was of Chinese origin, granted the protest, and entered a permanent injunction requiring termination of the Sea Box contract.

Although the Corps and, by extension, GAO, generally seemed willing to accept the offeror's characterizations, which maximized the significance of work in the U.S. while minimizing the work performed in China, the COFC strongly criticized this approach. It is true that, absent any specific reason for doubt, an agency may accept an offeror's TAA certification at face value. But once a question is raised, the agency must reach its own judgment and not rely on the offeror's. While the COFC accords some deference to the agency judgment, the agency should not extend the same courtesy to an offeror, who, after all, is an interested party.

Furthermore, the COFC found that Sea Box—which was not represented by counsel—had made a series of inconsistent statements during the procurement and protests, further indicating that those statements could not be relied on uncritically. For example, during proposal discussions Sea Box stated that the LFRS is electrically and mechanically integrated in China, but disavowed that statement in arguments to the COFC.

The COFC found that the components assumed their essential character and function as an LFRS as a result of their assembly and other operations in China. This substantial transformation establishes Chinese origin. The COFC relied principally on three factors. First was Sea Box's statements in documents submitted to the Corps (later recanted after the protests were initiated) that the LFRS underwent "final assembly" in China. Another factor was a qualitative comparison of work performed in China with that performed elsewhere. By the time the LFRS left China, the container structure and refrigeration system were complete and had been integrated, whereas in the U.S. only "finishing" tasks such as painting and installation of a light and transformer were performed. A third factor was a quantitative comparison of work volume. In contrast to the data cited in the GAO decision, this was based not on labor cost, but on labor time, which is arguably a better measure of substantial transformation given the wide difference between labor rates in the two countries. Unfortunately, the amounts of time are redacted, but one can infer that the labor time in China was substantially greater. Finally, and potentially most important, the LFRS underwent and passed ISO functional testing before leaving China. The testing itself was not deemed part of the manufacturing process because only prototypes underwent it, but it demonstrated that the LFRS was already capable of functioning as such when it left China.

The COFC rejected several other contentions that Sea Box or the Corps raised in support of the award. The COFC rightly found that the work in Singapore (a designated country) in manufacturing the refrigeration unit was immaterial. Although Sea Box based its initial TAA certification on the premise that its LFRS was a product of Singapore, that position was abandoned in litigation when Sea Box argued in favor of U.S. origin. The fact that a component came from Singapore cannot bolster a finding of U.S. origin, especially if that component is integrated with others before arriving in the U.S.

On the other hand, the manufacture of components in the *same* country as the place of assembly of those components (such as the shipping container in this instance) with imported components (such as the refrigeration module) can shift the balance toward a finding of substantial transformation at that place of assembly. For example, Customs has issued numerous rulings on the country-of-origin marking requirements for golf clubs. See, e.g., HQ 563286 (Customs, Aug. 25, 2005); HQ 562901 (Customs, Nov. 6, 2003); HQ 734256 (Customs, July 1, 1992); HQ 735792 (Customs, June 8, 1994). These rulings have consistently held that if both major components (i.e., the golf club heads and shafts) are imported into the U.S., there is no substantial transformation as a result of the U.S. assembly process regardless of the origin of the grip, which was considered a minor component. If either the head or the shaft is produced in the U.S., the non-U.S. component undergoes a substantial transformation as a result of the U.S. assembly operations.

Similarly, in HQ H013150 (Customs, Jan. 25, 2008), Customs found that the country of origin of a printer is the Netherlands, regardless of whether final assembly occurs in the Netherlands or the U.S. The imaging device that imparts the printer's essential character is produced in the Netherlands. Customs determined that when the final assembly operations involving parts from both Malaysia and the Netherlands are performed in the Netherlands, the parts from Malaysia undergo a substantial transformation such that the Netherlands is the country of origin of the printer. However, when the same finishing opera-

tions occur in the U.S., no substantial transformation occurs and the country of origin of the printer remains the Netherlands because the imaging device, which gives the printer its essential characteristic, is produced in the Netherlands.

The COFC also held that Sea Box could not cure noncompliance by offering after award and protest to move production to the U.S. This would have been a material change in its proposal, which cannot be allowed after the deadline for final proposals. To allow the change would also be inconsistent with the principle that the agency's action must be judged on the record at the time of award. Prohibiting post-award corrections is also likely to promote greater attention to compliance in the long run. Otherwise, the cynical and unscrupulous would be more tempted to misrepresent TAA compliance, knowing that, if caught, they could escape loss of the award by changing manufacturing plans.

It remains to be seen whether the Corps will now award to the compliant offeror next in line, and whether the Corps or Sea Box will appeal to the U.S. Court of Appeals for the Federal Circuit.

Customs Decisions Absent from the Analysis—A remarkable aspect of both decisions is that neither makes any reference to Customs' original decisions or analysis. Customs is the largest source of precedent on product origin, issuing decisions on substantial transformation for a number of purposes, such as product marking requirements, tariff classification and advisory opinions for procurement purposes. Such decisions are the primary legal authority on substantial transformation. Other GAO origin decisions have been guided by Customs precedents. See, e.g., *Pacific Lock Co.,* Comp. Gen. Dec. B-309982, 2007 CPD ¶ 191. Both the protester and the respondent cited Customs rulings to GAO and the Court, but unfortunately there are no precedents addressing refrigerated containers or the like. Although it is rare to find a prior ruling that closely matches a product whose origin is questioned, Customs decisions can illuminate the substantial transformation analysis and should not be overlooked in briefing a TAA dispute to GAO or the COFC.

Lessons—Several aspects of the *Klinge* decisions are instructive on complying with the TAA, defending one's compliance in a protest and challenging a competitor's compliance.

Putting the Agency on Notice of Possible Noncompliance: The agency's duty to conduct any inquiry into product origin and the offeror's duty to document product origin are only triggered after compliance has been questioned. This can occur after award in a protest, as in *Klinge*. But there could be advantages in raising and addressing the issue earlier, both for the agency and some offerors. For example, if an offeror knows his competition is largely or overwhelmingly from non-designated countries, it may draw this to the agency's attention before proposals are due and recommend that offerors be required to document product origin in initial proposals. The agency might decide to accept that advice, recognizing that failure to do so could lead to a protested award. Presumably in the LFRS procurement, the Corps would have preferred to conduct its origin analysis in the initial procurement if it had known there was a TAA issue.

Recognizing that the Record before the Agency Will be the Basis of Decision and that the Agency's Judgment on that Record Will Be Accorded Some Deference: As is the case with many issues it addresses, GAO assesses the reasonableness of the agency's judgment rather than conduct a de novo review and reach a conclusion independent of the agency's conclusion. This means that it is important to document one's analysis carefully when the agency requests information on product origin, as information provided later may be disregarded. The standard of review also ensures that the agency will enjoy some benefit of the doubt in a close case, a fact which must be considered before initiating a protest. On the other hand, it is important to note that an origin protest ultimately turns on objective facts (manufacturing steps, functions, locations) rather than value judgments. An origin protest may be contrasted, for example, with a protest challenging a trade-off of cost against technical merit, in which the customer's judgment as to what a benefit is worth can rarely be overturned. If one has reason to believe that a competitor's product simply cannot meet the substantial transformation test based on established precedents, there is reason for hope, even at GAO. On the evidence of the *Klinge* decision, however, the COFC may be inclined to further probe the agency's conclusion.

Consider Customs Precedents: Customs decisions should not be overlooked when seeking to develop a compliant manufacturing plan, or when filing or defending a protest. Of course, analysis of Customs decisions may be introduced when a protest is filed after award. If an agency requires origin documen-

tation in proposals, it may even be advantageous to cite supporting Customs decisions at that early juncture. If the agency can be persuaded to make its initial decision in a particular contractor's favor, that contractor will be a step ahead in a later protest because GAO will give the benefit of the doubt to the initial result.

Quantifying Cost and Labor Hours: The Corps and GAO seem to have relied rather heavily on the costs of U.S. operations relative to costs incurred in China and Singapore, whereas the COFC cited labor time. Although it is never dispositive in Customs analysis of substantial transformation, cost of operations is undoubtedly an indicator that can be taken into account along with other indicia. Cost is a function of both *volume* of inputs (e.g., labor hours, amount of material) and unit *prices* of those inputs. Of course, the primary reason for sourcing production in China is vastly lower prices for labor and other manufacturing inputs. Thus the size of a U.S. cost component relative to Chinese cost components is likely to be affected more by the labor price differential than the substantiality of the U.S. manufacturing operations. One might reply that dollars are important because they are a measure of benefit to the local economy, but legally the only issue is where the product takes on its essential identity, character and use, not what country gets the most economic benefit from its production. Depending on what side of the argument one is on, it may be more advantageous to argue labor hours than cost, or vice versa.

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