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DOD Anti-Counterfeit Rule Requires Immediate Action

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Law360, New York (May 19, 2014, 5:39 PM ET) -- Counterfeit electronics remain one of the most vexing contracting problems facing the U.S. Department of Defense. The widespread existence of counterfeits is undisputed; entire sections of certain foreign locales are dedicated to their production and distribution. The risks posed by counterfeits likewise are real and range from early product failure to potential national security catastrophes.

To one unfamiliar with the market forces, the dependence of the DOD on commercial electronics (and its limited control over the market), the obsolescence conundrum, the complicity of certain foreign governments, the economics of rigid testing, and the sophistication of counterfeiters, the solution might seem simple: Ban counterfeits and punish the federal contractors that deliver them. Of course, a real fix must target the causes of the problem, not the symptoms.

On Dec. 31, 2011, President Obama signed into law the National Defense Authorization Act for Fiscal Year 2012. P.L. 112-81, 125 Stat 1298 (2011).[1] Alerted to the problem of counterfeits, Congress identified in Section 818 of the act sweeping new obligations for the private sector related to counterfeit parts. The act, passed in the wake of a high-profile investigation by the Senate Armed Services Committee, contains ample consequences and few safe harbors for contractors. Significantly, for purposes of this article, the act left much of the implementation detail to the regulatory process, requiring the secretary of defense to issue new anti-counterfeit regulations within 270 days.

On May 6, 2014, the DOD issued its final anti-counterfeit rule, amending the DOD Federal Acquisition Regulation Supplement (DFARS).[2] The rule took effect immediately, and is available here. Not surprisingly given Section 818's mandate, the rule levels a series of new requirements at contractors and subcontractors that supply or incorporate into their products (or services) the provision of electronic parts.

New Requirements for Contractors and Subcontractors

Contractors subject to the rule — that is, contractors subject to the Cost Accounting Standards under § 26 of the Office of Federal Procurement Policy Act (41 U.S.C. § 422) and that supply electronic parts or products that include electronic parts — must establish and maintain a counterfeit electronic part detection and avoidance system in compliance with the new rule. The rule also contains flow-down provisions requiring that all subcontractors at all tiers, including subcontractors for commercial items and commercial-off-the-shelf items, must also establish and maintain counterfeit electronic part detection and avoidance systems.

New Counterfeit Detection and Avoidance System

Contractors and subcontractors subject to the rule must move quickly to establish a counterfeit electronic part detection and avoidance system or to modify an existing system to come into compliance with the rule. The rule became effective May 6, 2014, and the requirements take immediate effect. The

consequences of noncompliance can be significant, including withholding payments under a contract. Systems must address, at a minimum, the following 12 areas in order to qualify as an "acceptable" plan under the rule:

1. The training of personnel.
2. The inspection and testing of electronic parts, including criteria for acceptance and rejection.
3. Processes to abolish counterfeit parts proliferation.
4. Processes for maintaining electronic part traceability.
5. Use of suppliers that are the original manufacturer, sources with the express written authority of the original manufacturer or current design activity, including an authorized aftermarket manufacturer or supplier that obtain parts exclusively from one or more of these sources.
6. The reporting and quarantining of counterfeit and suspect counterfeit electronic parts.
7. Methodologies to identify suspect counterfeit electronic parts and to rapidly determine if a suspect counterfeit electronic part is, in fact, counterfeit.
8. Design, operation, and maintenance of systems to detect and avoid counterfeit electronic parts and suspect counterfeit electronic parts.
9. Flow-down of counterfeit detection and avoidance requirements to subcontractors and suppliers.
10. Processes for keeping continually informed of current counterfeiting information and trends.
11. Processes for screening the Government-Industry Data Exchange Program (GIDEP) reports and other credible sources of counterfeiting information.
12. Control of obsolete electronic parts.[3]

The new system applies not only to contracts going forward but also to existing contracts and parts already in the contractor's possession.[4]

The rule provides little direction as to how contractors and subcontractors should meet these standards. Although the absence of specific direction generally may benefit contractors by allowing them to employ existing industry practices that best fit their specific business risks and needs, it also leaves some uncertainty.

The rule expressly directs contractors to use "risk-based policies and procedures" and to employ "accepted government- and industry-recognized techniques" for tests and inspections.[5] In the preamble, the DOD suggests that the risk level will be "based on the potential for receipt of counterfeit parts from different types of sources," and that "the potential for counterfeit electronic items is considerably lower when the item is procured from authorized sources and retains traceability." [6] The

rule thus recognizes that "requiring the contractor to test and inspect all electronic parts would be prohibitive," and permits contractors to make risk-based decisions "based on supply chain assurance measures." [7]

The DOD further signaled its approval for use of industry standards. The preamble notes that contractors may look to industry consensus standards for their systems, and that the DOD has and will continue to participate in developing industry standards. The DOD acknowledged, however, that current industry standards on counterfeit parts vary and continue to evolve, meaning that there may not be a single consensus standard. It was for this reason that the DOD did not prescribe particular standards in the new rule. [8] The DOD's decision not to prescribe particular standards shifts the burden to contractors to determine what industry standards exist and which standards best fit a contractor's counterfeit detection and avoidance needs. The contractors must also bear the risk if they get it wrong.

Ultimately, the DOD has authority to determine whether a system is "acceptable." According to comments in the rule's preamble, it may take some time — up to 10 years — for the DOD to review all of the new systems and make these determinations. [9] Thus, any further clarification that might come from the DOD's review and feedback on contractors' systems may not be readily forthcoming.

Flow-Down to Subcontractors

Another immediate task for covered contractors is to ensure that subcontractors also comply with the new requirements through subcontract flow-down provisions. The rule requires contractors to include provisions in their subcontracts requiring subcontractors to establish and maintain a counterfeit detection and avoidance system.

Subcontractors of covered contractors must establish and maintain counterfeit electronic part detection and avoidance systems addressing the same 12 areas. The flow-down requirement makes contractors responsible for ensuring subcontractor compliance and may significantly expand the burden on contractors. In addition to determining how to meet the standards imposed by the new rule for their own companies, contractors will need to determine what is required of their subcontractors and monitor subcontractor compliance. Contractors may need to become familiar with industry standards for a new area of business in order to ensure compliance by their subcontractors.

Reporting Issue

One of the many issues raised by this rule relates to reporting counterfeit or suspect counterfeit parts. The rule requires contractors to report to the contracting officer and to GIDEP. [10] Beyond this requirement, the DOD noted in the preamble that some, but not all, counterfeit or suspect counterfeit parts may need to be reported to the DOD inspector general under mandatory fraud disclosure requirements. [11] The determining factor would be the existence of fraud in procurement of the counterfeit or suspect counterfeit part. The DOD's view appears to be at odds with the IG's view that contractors should report all counterfeit or suspect counterfeit parts to the IG through the mandatory disclosure process. [12] The DOD and the IG should provide clarity to contractors on this reporting issue. [13]

Oversight

The Defense Contract Management Agency will monitor contractor compliance with the rule as part of the contractor purchasing system review process. The rule adds these compliance obligations to the existing purchasing systems requirement. In addition, the DCMA is developing a "Counterfeit Detection and Avoidance System Checklist" to provide additional guidance to contractors.[14] Failure to establish and maintain an acceptable counterfeit electronic part avoidance and detection system could result in disapproval of a contractor's purchasing system and withholding of payments. The DOD also proposes an alternative clause that adds systems criteria for a less comprehensive review of the contractor's purchasing system, which targets review of those elements related to the detection and avoidance of counterfeit and suspect counterfeit electronic parts, for use in solicitations and contracts that do not include the clause present at FAR 52.244-2 (Subcontracts).

Costs/Liability

The rule holds contractors liable for the costs of any counterfeit or suspect counterfeit parts, as well as any rework or corrective action costs required to remedy the use of such parts. A narrow safe harbor exception exists, but it is so narrow as to be meaningless to most contractors. The DOD will exempt a contractor from costs and corrective action liability where the contractor (1) maintains a DOD-approved counterfeit parts compliance system, (2) receives the counterfeit parts as government-furnished property, and (3) provides timely notice. Note that all three requirements must be met.[15]

Further, as noted above, the failure to establish and maintain an acceptable counterfeit electronic part avoidance and detection system could result in disapproval of the contractor's purchasing system and withholding of contract payments.

Conclusion

The new DOD rule targets the significant issue of counterfeit electronic parts by requiring entities in the defense supply chain to take steps to detect and avoid such parts. These DFARS amendments require immediate compliance and could have a serious financial impact on contractors and subcontractors that fail to meet the requirements of the new rule. Although the DOD recognizes the risks inherent in supplying obsolete parts for long-lifecycle DOD systems, the rule (and underlying statutory provisions) largely shifts the burden — and resulting liability — for fighting counterfeit parts to contractors.

While uncertainty remains for contractors that must now comply with this rule, the rule conveys the DOD's intent to pursue further government-industry dialogue on the issue of counterfeit parts, noting in the preamble that future changes to the DFARS regulations "will be considered as they are identified." [16]

The first opportunity for dialogue will occur in a public meeting regarding the rule scheduled for June 16, 2014.[17] Contractors should therefore consider raising with the DOD (directly or indirectly through industry groups) ongoing issues raised by the implementation of these DFARS amendments. Contractors must also continue to be diligent in monitoring for potential counterfeit parts and any future changes to these DFARS regulations, and should take immediate steps to ensure compliance with the new rule.

[1] Congress amended the Act in part by the 2013 National Defense Authorization Act. National Defense Authorization Act for Fiscal Year 2013, Pub. L. 112-239 (Jan. 2, 2013), Section 833.

[2] 79 Fed Reg. 26092-01 (May 6, 2014).

[3] Id. at 26106-26107 (48 C.F.R. § 246.870-2).

[4] Id. at 26099.

[5] Id. at 26108 (48 C.F.R. §§ 252.246-7007(c)(2), (8)).

[6] Id. at 26096.

[7] Id.

[8] Id. at 26102.

[9] Id. at 26105.

[10] Id. at 26107-26108 (48 C.F.R. §§ 246.870-2(b)(6), 252.246-7007(b)(6)).

[11] Id. at 26103.

[12] See <http://www.dodig.mil/programs/CD/index.html>.

[13] Open FAR Case 2013-002, Enhanced Reporting of Nonconforming Parts, will address requirements to report to the contracting officer and GIDEP, but may not address the requirement to report to the IG. The Office of Information and Regulatory Affairs (OIRA) is currently reviewing the draft proposed rule.

[14] 79 Fed. Reg. at 26096.

[15] Id. at 26106 (48 C.F.R. § 231.205-71(b)).

[16] Id. at 26093.

[17] 79 Fed. Reg. 26725-01 (May 9, 2014).

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