

Department of Defense Issues Proposed Rule For The Detection And Avoidance Of Counterfeit Parts

The Department of Defense (DoD) has just issued a proposed rule to address contractor responsibilities to detect and avoid counterfeit or suspect counterfeit electronic parts in the defense supply chain. 78 Fed. Reg. 28780 (May 16, 2013). The proposed rule imposes new obligations on the private sector, onto which it shifts most of the responsibility to detect counterfeit parts. Contractors should be aware of these obligations and focus on preparing for the new anti-counterfeit rules. Public comments are due within 60 days.

Overview of Statutory Requirements

DoD's proposed rule, Detection and Avoidance of Counterfeit Electronic Parts (DFARS Case 2012-D055), partially implements Section 818 of the National Defense Authorization Act for Fiscal Year 2012 (NDAA). Section 818 imposes new requirements on DoD and the Department of Homeland Security, and requires that DoD issue comprehensive new regulations as to defense contractors that supply electronic parts or products that include electronic parts. Section 818(c) mandates that DoD revise the DFARS to hold contractors responsible for detecting and avoiding counterfeit electronic parts, require contractors to use trusted suppliers, and require contractors to report counterfeit or suspect counterfeit parts that have entered the supply chain. Section 818(c) also requires that DoD revise the DFARS to make unallowable the costs of counterfeit and suspect counterfeit electronic parts, as well as the costs of any rework or corrective action necessary as a result of the use of counterfeit or suspect counterfeit parts. Section 833 of the NDAA for Fiscal Year 2013 amended Section 818 to provide a narrow exception to this cost-shifting provision. Pub. L. 112-239 (2013). In addition, Section 818(e) more generally requires DoD to implement a program to enhance contractor detection and avoidance of counterfeit electronic parts.

DoD appears to have exercised limited discretion in designing the proposed rule. For the most part, the proposed rule incorporates the NDAA statutory language into the DFARS, without providing additional detail as to how contractors are to meet the statutory requirements or DoD's interpretation of those requirements.

The Proposed DFARS Amendments

Definitions. DoD first proposes to add key definitions to DFARS 202.101 for "counterfeit part," "suspect counterfeit part," "electronic part," and "legally authorized source." DoD's attempt to capture all types of unauthorized parts within its definition of "counterfeit part" has rendered the definition overbroad. The proposed definition includes "[a] new, used,

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outdated, or expired item from a legally authorized source that is misrepresented by any source to the end-user as meeting the performance requirements for the intended use.” On its face, this definition appears to capture genuine parts that do not perform as represented.

Systems. The proposed rule requires that contractors establish and maintain an “acceptable” counterfeit avoidance and detection system, to include, at a minimum, the general criteria listed in the NDAA:

- Training personnel;
- Inspection and testing, including rapid testing of suspect parts;
- Processes to abolish counterfeit parts proliferation;
- Traceability of parts to suppliers;
- Use and qualification of trusted suppliers;
- Reporting and quarantining of counterfeit and suspect parts; and
- Detection and avoidance systems.

This system must also include similar flow down requirements to subcontractors. The rule does not detail how contractors should satisfy the above requirements nor explain whether a system that includes the above criteria in some form will be deemed “acceptable” or how such determinations will be made. Inexplicably absent from the criteria are a number of specific requirements in Section 818(c) of the NDAA, such as the requirement that contractors notify DoD when a contractor obtains parts from any source other than a trusted supplier and report counterfeit or suspect parts within 60 days. The proposed rule also does not detail what qualifies as a “trusted supplier,” nor does it address the provision in Section 818(c) permitting contractors to identify and use additional trusted suppliers when certain conditions are met. The preamble generally notes that DoD will separately implement other aspects of Section 818, however, it does not specifically address the missing requirements from 818(c).

Oversight. DoD will review and monitor a contractor’s system for detecting and avoiding counterfeit or suspect counterfeit electronic parts as part of a contractor’s

purchasing system review. To that end, DoD proposes to add several compliance obligations to the existing purchasing systems requirements. A contractor’s failure to establish and maintain an acceptable counterfeit electronic part avoidance and detection system may result in disapproval of the purchasing system and/or withholding of payments. 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 and Liability. Finally, the proposed DFARS provisions dictate that covered contractors, which are those subject to the Cost Accounting Standards under § 26 of the Office of Federal Procurement Policy Act (41 U.S.C. § 422) and supply electronic parts or products that include electronic parts, will be responsible for the costs of any counterfeit or suspect counterfeit parts, as well as any rework or corrective action costs that may be required to remedy the use of such parts. Per Section 833, the proposed rule contains a narrow exception for when such costs may be allowable. A disparity exists, however, between the language in the proposed rule and the preamble regarding this statutory exception. The preamble provides that the exception exists for contractors that have a DoD-approved operational system to detect and avoid counterfeit parts *or* receive the suspect counterfeit parts as Government-furnished property *and* (in both cases) provide timely notice of counterfeit parts to the Government. The text of the proposed rule, however, describes a far more limited exception that relieves the disallowance *only* where the contractor meets all three criteria: (i) maintains a DoD-approved counterfeit parts compliance system, (ii) receives the counterfeit parts as Government-furnished property, *and* (iii) provides timely notice. DoD will need to clarify this disparity before finalizing the proposed revisions.

Conclusion

On the surface, the proposed rule may seem superficially appealing. It seeks to address 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, however, could have a serious financial impact on many contractors and subcontractors. Namely, the regulations largely shift the burden — and resulting liability — for fighting counterfeit parts to contractors. Furthermore, in rendering unallowable the costs to remove and replace counterfeit parts, the regulations (and underlying statutory provisions) ignore that even those contractors that have comprehensive and robust compliance systems can fall victim to increasingly sophisticated counterfeiters. Contractors must therefore continue to be diligent in monitoring for potential counterfeit parts and should take steps now to implement systems to ensure compliance with the anticipated anti-counterfeit rules.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or the following attorneys:

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