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DOD Counterfeit Parts Rule — So Little After So Long

Law360, New York (June 04, 2013, 1:16 PM ET) -- On May 16, 2013, the long-awaited proposed Defense Federal Acquisition Regulation Supplement on detection and avoidance of counterfeit parts was released for comment. Required by Section 818 of the 2012 National Defense Authorization Act, the DFARS was to have been in place by Sept. 27, 2012. Instead, eight months after the original due date, we have a "proposed rule" with comments due on or before July 15, 2013.

Industry has been anxiously awaiting the proposed rule. Now that it has arrived, finally, those who were expecting meaningful guidance surely will be disappointed. There is relatively little detail in the proposed rule. The statute clearly directed the U.S. Department of Defense to establish special requirements for contractor processes to avoid counterfeit parts, but the proposed rule largely avoids this. Instead, it folds counterfeit parts prevention into obligations that govern contractor purchasing systems. This is an imperfect choice, which fails to inform contractors of how they can minimize compliance risk.

What the Rule Does

The rule applies only to "electronic parts," in contrast to the DOD's new Counterfeit Prevention Policy, DoDI 4140.67, released on April 26, 2013, which applies to counterfeit "materiel." It begins with an attempt to define a "counterfeit part" — a subject that has provoked much debate. One part of the definition treats as a counterfeit part a "new, used, outdated, or expired item procured from a legally authorized source that is misrepresented by any source to the end user as meeting the performance requirements for the intended use." This aspect to the definition would treat as "counterfeit" even items newly made by original manufacturers that happen to fail acceptance test. An ordinary defect missed by the quality system would be "misrepresented" at the time that a DD250 or equivalent is presented for customer acceptance.

Also problematic is the definition of "suspect" counterfeit part: "a part for which visual inspection, testing, or other information provide reason to believe that a part may be a counterfeit part." This leaves more to be resolved than it answers. The costs of "suspect" as well as confirmed counterfeit parts are unallowable as well as the costs of remedial "rework or corrective action." For the higher tier contractors subject to the rule, a great deal of financial exposure is present should even a suspect

counterfeit part enter into a system and require extensive remedial effort. The new definition does point to objective sources of information (visual inspection, testing) but provides no definite basis to determine what is a “suspect counterfeit” part. Nor does it recommend a process or identify an industry standard to consult.

A new contract cost principle, 231.205-71, is proposed to address the cost of “remedy” for use or inclusion of counterfeit electronic parts. It makes unallowable the costs of counterfeit or suspect counterfeit electronic parts and the cost of “rework or corrective action.” The reach of the exclusion is not defined as the proposed regulation does no more than restate the terms of Section 818(c)(2). It does not wholly align with the recent DoDI, which makes it an objective of the DOD to obtain “remediation” and establishes a policy to seek “restitution” when cases of counterfeit parts are confirmed. Industry will want greater clarity on the definition of unallowable costs. Also, as drafted, the cost principle could apply beyond Cost Accounting Standards-covered contractors, as was intended by Section 818, to all contractors subject to the cost principles. This is because proposed 231.205-71 (c), which disallows costs of counterfeit and rework, is not expressly limited to CAS-covered contractors as is 231.205-71(b).

As expected, the proposed rule would amend DFARS Subpart 246 (Quality Assurance) to include policy and procedures to implement Section 818. But the substance of the proposed policy, presented at 246.870-2, is thin. While Congress may have expected the DOD to define and describe the elements of a contractor system to eliminate counterfeit electronic parts, the proposed regulation is essentially a word-for-word recitation of Section 818 (e)(2), no more.

Included in this part of the proposed rule, at 246.870-3, is a form of contract clause to be included in many solicitations — including those where a contractor is procuring “material containing electronic parts or services where the contractor will supply electronic components, parts, or materials as part of the service." Potentially, this clause will extend the counterfeit prevention regime beyond hardware to companies that use electronic systems to provide services to the DOD.

The bulk of the proposed rule focuses on contractor purchasing systems. Among required “system criteria” for an “acceptable” purchasing system are procedures to include counterfeit parts avoidance requirements in purchase orders and flow these down to subcontracts. An acceptable purchasing system also is to ensure that sources meet the requirements of counterfeit parts detection and avoidance. In the event of a “significant deficiency,” which could include failure to meet requirements for counterfeit part avoidance and detection, the government could disapprove a purchasing system and withhold payments.

What’s Missing From the Rule

The proposed rule is surprisingly sparse, considering the very long gestation and the reported intensity of interest among many DOD components. In substantial fraction, the regulation recites the statute rather than explain how it is to be interpreted or applied. Many companies have wanted more detailed guidance about how to apply the broad requirements of Section 818 that address so many junctures of supply chain security.

The statute, at Section 818 (e)(2), requires DoD to implement a program to require contractors to establish “policies and procedures” to detect and avoid counterfeit electronic parts. Companies are at risk of business system scrutiny and potential payment withholds, among other sanctions, if their counterfeit prevention systems are deficient. The proposed rule takes something of a “diffident” approach to this requirement. Rather than imposing new requirements for systems to avoid counterfeit parts, the rule only recites the statute, in adding counterfeit prevention to quality assurance, and proceeds to graft elements of counterfeit parts prevention onto the existing DFARS treatment of purchasing systems.

Purchasing is very much a component of supply chain risk management. But there are many other relevant functions that are outside purchasing — such as design, engineering, quality assurance, materiel management and accounting, compliance and the like. Introduction of counterfeit avoidance, as a factor in the adequacy of a purchasing system, poses the risk that a counterfeit incident could cause the DOD to withdraw purchasing system approval. This could literally stop a major contractor in its tracks even if the counterfeit intrusion had nothing whatsoever to do with purchasing practices and controls.

Another peculiarity is that the rule skirts but does not answer what for many companies has been the “big question” about implementation of Section 818.

There is all but universal agreement that purchasing from original sources (OCMs or OEMs or their authorized distributor) is the best way to avoid counterfeit parts. This is recommended by Section 818(c)(3)(A)(i). But the law, at section 818(c)(3)(A)(ii), also recognizes that parts may not be available from these sources; in that case, the law directs industry to acquire parts from “trusted suppliers” and thus requires additional testing and inspection, and customer notification, when parts are acquired from other than original sources.

There are literally thousands of deployed DOD systems that require parts for sustainment where there is no supply available from the original sources. The quandary, repeated many times daily, is that industry must avoid counterfeits even though it has no choice other than to purchase from sources not among those preferred from the statute. Yet — the regulation offers neither instruction nor information on how to identify or qualify a “trusted supplier” where not an original source, or on how to determine what additional test or inspection to perform, or on what role the customer is to play in source approval. In the same vein, the statute recognizes that there are “industry standards” that should guide the qualification of “trusted suppliers” where original sources are not available. The proposed regulations are completely silent on the subject and offer no guidance as to which industry standards should be followed or how companies should act upon these standards.

The statute, at Section 818(b)(2), directs the DOD to implement a “risk-based approach” to deal with the risk of counterfeits in its own purchasing practices. This proposition recognizes that it is impossible to eliminate all risk of counterfeit in every system that the DOD buys or supports. What is feasible is an information-driven method to select and give special attention to those systems where the presence of

a counterfeit would do the greatest harm, either to operations or personnel safety.

Risk-based assessment also would give priority to prevention efforts where the threat is greatest that an unscrupulous actor can fabricate a counterfeit part that could elude detection and "escape" into the supply chain. Also to be considered is vulnerability, where unfulfilled demand for certain parts, no longer available from secure sources, exposes the supply chain to nonconforming surrogates. Counterfeit parts prevention is costly. Not all desirable actions are feasible or affordable. Hence, it borders on the irresponsible that the proposed DFAR does nothing to guide industry in setting risk-based priorities and offers neither standards nor assurance that "best efforts" will limit contractor liability.

One of the least desirable features of Section 818, though it was a well-intended statute, is that it operates to impose "strict liability" on covered contractors (large DOD companies) not only for the costs of replacing a counterfeit part but also for the potentially enormous remediation costs should there be an accident or a requirement to disassemble and rebuild a complex system to rid it of counterfeit risk.

DOD contractors have some influence over counterfeit prevention risk, to be sure, but they did not create that risk and they do not have absolute authority over requirements or sources, much less the time or funds to insist upon parts with perfect "provenance" or pedigree. Hence, it is most important to responsible companies that the DOD provide guidance on what is expected and that the DOD implement an oversight and enforcement mechanism that credits companies for their efforts and forbears from irresponsible, punitive actions. The proposed rule offers no comfort here.

In its treatment of small business, the rule arguably is disingenuous and, at worst, contradictory. Introductory comments to the proposed rule indicate that the rule does "not apply to small entities as prime contractors" and that there is only a "negligible" impact on small entities in the supply chain. While the proposed rule applies directly only to a CAS-covered contractor, they are required to flow down "counterfeit avoidance and detection requirements" to all subcontractors. Since larger primes rely on a supply chain of many tiers and inclusive of many small businesses, there should be no doubt that this rule will impact small business.

What remains to be seen is how they can afford to comply — already there is anecdotal evidence that many primes have confronted refusals even from valued suppliers to sign up to assume liabilities to a prime should they furnish a counterfeit item. Primes are not excused if a small business is the source of a counterfeit electronic part. Moreover, analytically, the DOD should be just as concerned about the impact of a counterfeit from a small business as from a large contractor — should a system fail, it will make no difference operationally that the supplier was a small business ostensibly outside the new DFARs.

The best that can be said of the proposed rule is that it is does not attempt to go too far or do too much — it is neither prescriptive nor effective upon issuance. Many in industry had worried that the DOD would attempt to impose a rigid rule structure on a diverse and dynamic industrial base. That has not occurred, but the DOD has a long way to go before its regulatory implementation of Section 818 meets what Congress expected.

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