Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

You Don't Have To Report Counterfeits To DOD IG

Law360, New York (October 06, 2014, 5:25 PM ET) --

Robert Metzger

Law360 on Sept. 30, 2014, published an article, “DOD Pushes Contractors To Keep Reporting Counterfeits to IG,” in which Randy Stone, the U.S. Department of Defense’s deputy inspector general for policy and oversight, urged contractors to continue to report to the DOD IG when they discover counterfeit electronic parts. The new Defense Federal Acquisition Regulation Supplement rule on counterfeit parts detection and avoidance, finalized in May 2014, requires reporting to the contracting officer and the Government-Industry Data Exchange Program (GIDEP), but not to the IG.

Stone was quoted in Law360:

A contractor disclosure seems to be the best way to have a record of the report and to provide the information to the appropriate government agencies for review and action deemed to be appropriate.

Those results, he continued, “are then documented in the disclosure file for review later if needed.” Stone also urges contractors to make disclosures about suspected counterfeit or nonconforming parts as well as confirmed counterfeits:

Keep in mind a suspected counterfeit part or a nonconforming part can turn into an actual, legitimate counterfeit part. The only way to properly determine the outcome is for a law enforcement agency to review and conduct an investigation if warranted.

These comments spotlight several key issues arising from the new DFARS. To whom must a contractor report a suspect or confirmed counterfeit electronic part? Are contractors obligated to make disclosures to the DOD IG of nonconforming parts?

Congress enacted Section 818 to the fiscal year 2012 National Defense Authorization Act late in 2011. It requires DOD components and contractors to improve reporting of suspect and confirmed counterfeit electronic parts. Section 818(b)(4) obligates department personnel to report to “appropriate Government authorities” and to the GIDEP, or a similar program. Section 818(c)(4) requires contractors subject to the law also to report to “appropriate Government authorities” and to GIDEP. The legislation makes no mention of the DOD IG and does not identify who or what might be “appropriate Government

authorities" to whom reporting must be made.

The statute envisions, at Section 818(c)(1), that contractor responsibilities will be addressed by new DFARS regulations. Those were promulgated on May 6, 2014, at 79 Fed. Reg. 26092. The promulgation comments state that the new clause, at DFARS 252.246-7007, is "expanded in the final rule to provide information on where to report, what to report, and the circumstances that require a report." 79 Fed. Reg. 26098. Accordingly, the DFARS implements the statutory reporting mandate and controls the applicable reporting requirements.

DFARS 252.246-7007 states the 12 criteria that a contractor must address in its system to detect and avoid counterfeit electronic parts. It clearly states that reporting "is required to the Contracting Officer and to the Government-Industry Data Exchange Program." The regulation, therefore, establishes that the contracting officer is the "appropriate" Government authority to whom a report must be made. The regulation does not identify the inspector general as a party to receive such a report.

In fact, as evident from the promulgation comments, the drafters of the DFARS considered and rejected the proposition that a contractor must report both to the contracting officer and to the DOD IG. The comments state that "[n]ot all counterfeit or suspect counterfeit parts are due to fraud, and, in any case, reporting of fraudulent activity to the DoD IG is already required by various DoD and Governmentwide clauses and provisions." 79 Fed. Reg. 26103.

Accordingly, the DFARS is unambiguous that this rule does not require reporting to the DOD IG. The promulgation comments recognized that reporting is addressed by another rulemaking, FAR Case 2013-002, and suggested that through this FAR case the reporting requirements "will be clear" as will be "the existing requirement (at other parts of the FAR and DFARS) to report fraud to the IG." 79 Fed. Reg. 26103

The referenced FAR case 2013-002 produced a proposed rule on expanded reporting of nonconforming items, published on June 10, 2014, at 79 Red. Reg. 33164. The proposed rule would expand reporting obligations beyond Section 818, which is limited to DOD contractors (and specifically to Cost Accounting Standards-covered DOD contractors) and to electronic parts that are considered counterfeit or suspect counterfeit. If finalized in the form as proposed, it would require reporting of "nonconforming parts" if the contractor becomes aware that an item is a counterfeit or suspect counterfeit or if it is a common item that contains a "major or critical nonconformance" which constitutes a "quality escape." Proposed FAR 52.246-XX ("Reporting Nonconforming Items") at 79 Fed. Reg. 33168. The Proposed Rule requires reporting of a counterfeit or suspect counterfeit part to the Contracting Officer within 30 days. It requires reporting to GIDEP within 60 days of a counterfeit (or suspect) part or of a major or critical nonconformance.

The proposed FAR on expanding reporting does not require disclosure of either a counterfeit or suspect counterfeit, or of a major nonconformance, to any federal inspector general. The reporting obligations explicitly and unambiguously point to the contracting officer and to GIDEP. A comment that precedes the proposed rule suggests that it is through the contracting officer (or GIDEP) that law enforcement authorities are to be notified:

In addition, a contractor must report to the contracting officer under certain circumstances, which are different from those requiring the contractor to report to GIDEP, for example when a counterfeit or suspect counterfeit item is identified, without regard to whether the contractor intends to deliver the product containing the counterfeit or suspect counterfeit items. This is necessary so that the

appropriate authorities, e.g., the Department of Justice or the agency Inspector General, can follow up with the item's supplier.

79 Fed. Reg. 33166. The proposed rule is not final, of course, and changes may be made to the draft that was proposed in June 2014. As it stands, however, nothing in either the final DFARS counterfeit parts rule, or in the proposed FAR that expands reporting, obligates a contractor to report either a counterfeit or suspect counterfeit electronic part, or any other nonconformance, to the DOD or any other inspector general.

In the Law360 interview, Stone recognizes that a new reporting rule is in the works. He comments that there would be more reporting to the IG "[i]f this new rule identifies DOD IG as the responsible agency and reporting through the Contractor Disclosure Program." This is not the content of the proposed rule, however, as it stands.

Setting aside the role of the inspector general, there are many and powerful reasons that industry should act diligently to improve its reporting of counterfeit electronic parts. (Whether to expand reporting duties to other nonconforming parts is beyond the scope of this article.) The investigation that preceded Section 818 revealed inconsistent and insufficient reporting practices. Vigilance in reporting is necessary and several purposes are served. These include informing the customer and end user of any potential threat that a counterfeit part might present to the operation of a government system or to the safety of personnel. It also is important to disseminate information about counterfeits among the broader supply chain community so that the risks can be known to and avoided by other potential users. Reporting to the contracting officer serves the first purpose. Reporting to GIDEP serves the second purpose.

Law enforcement has an important role to play. All participants in the federal supply chain share an interest in successful prosecution of actors who are responsible for counterfeiting and attempts to insinuate counterfeit electronic parts into defense electronics.

The IG can receive information from the contracting officer and from GIDEP. Stone, in the Law360 interview, acknowledged that the DOD IG coordinates with GIDEP. Contracting officers can be encouraged to contact the DOD IG if they conclude that a report on a suspect or confirmed counterfeit electronic parts warrants IG attention.

The DOD IG manages the disclosure program as required by FAR 52.203-13 (Contractor Code of Business Ethics and Conduct) and reinforced by FAR 9.406-2(b)(vi), which makes knowing failure to disclose such information a cause for debarment. The OIG website, on the Contractor Disclosure Program, presently states the following:

Counterfeit Parts Reporting

National Defense Authorization Act (NDAA) for fiscal Year 2012, Section 818, requires Defense contractors report suspected electronic counterfeit parts or non-conforming parts to the government. Contractors should report through the submission of a contractor disclosure. All other reporting requirements remain in effect, to include entry into the Government-Industry Data Exchange Program (GIDEP) database, or similar programs.

See http://www.dodig.mil/programs/CD/index.html.

This instruction is contrary both to Section 818 and the implementing DFARS. Neither require that a report made to a contracting officer and to GIDEP must also be made to the IG. A contractor that reports a suspect or confirmed counterfeit electronic part may have done nothing improper itself. Contractors subject to the DFARS must have systems to detect and avoid counterfeit electronic parts. The purpose of such a system is fulfilled — not violated — if the company identifies a "suspect" or confirms a "counterfeit" electronic part as it therefore has accomplished both "detection" and "avoidance" of a counterfeit.

Finding such a part triggers a GIDEP report and notification to the contracting officer. DFARS 252.246-7007(c)(6). The making of such a report is consistent with the proper operation of the required system to detect and avoid counterfeit electronic parts and therefore is in compliance with the DFARS regulation. Hence, there is no "violation" for the contractor to report to the IG.

The final DFARS rule defines a "counterfeit part" as a part that has been "knowingly mismarked, misidentified, or otherwise misrepresented." DFARS 252.246-7007(a). If a contractor succeeds in detecting a counterfeit or has credible evidence that a part is suspect counterfeit, in typical cases the party making the discovery is not the culpable person or enterprise that engaged in the "knowing" activities that produced the counterfeit.

In contracts subject to FAR 52.203-13 ("Contractor Code of Business Ethics and Conduct"), the obligation to make a disclosure to the IG arises when the contractor has "credible evidence" that a "principal, employee, agent, or subcontractor" of the contractor has committed a "violation of Federal criminal law" involving fraud (or other conduct not here relevant) or violated the False Claims Act. (The "credible evidence" standard used to trigger a disclosure is not the same as the technical measure of "credible evidence," referencing visual inspection or testing, that is incorporated in the definition of a "suspect" counterfeit electronic part in the new DFARS.)

In situations where a contractor subject to both the new DFARS and the FAR disclosure obligation uncovers a counterfeit, it has not engaged in any fraud or violated the False Claims Act. It may not know the actual source of the counterfeit or suspect part, as the covered contractor may have received the part from intermediaries in the supply chain, or in an assembly, where the "author" of the counterfeit is downstream but not knowable. In such situations, there should be no obligation on the part of the discovering contractor to make a disclosure, since it did nothing wrong, and no obligation to make a disclosure of violation on the part of its subcontractor unless there is evidence the subcontractor engaged in some knowing misconduct.

As to nonconforming parts, the IG's position is even more tenuous. A counterfeit part, as defined in the DFARS, is one that has been "knowingly mismarked, misidentified, or otherwise misrepresented." DFARS 202.101, at 79 Fed. Reg. 26106. In contrast, the definitions of nonconformance at FAR 46.101 include no intent element and instead are based upon the functional impact of the nonconformity. The presence of a nonconformity, as may routinely be discovered by operation of a contractor's Quality Management System, does not itself establish violation of any law, much less a federal criminal law involving fraud or the False Claims Act.

For these reasons, the DOD IG instruction and Stone's position, as expressed in Law360, are incorrect. They would impose substantial burdens upon contractors that are not called for by Section 818, the final DFARS or even suggested by the proposed FAR that expands reporting obligations.

Especially objectionable is the notion that any nonconforming part — whether or not counterfeit or

suspect — should trigger an IG reporting obligation. DOD contractors encounter nonconforming parts for a myriad of reasons and elaborate systems exist to resolve and correct such nonconformities. While a product nonconformance conceivably can be the product of a wilful misconduct or fraud, e.g., in a case of "product substitution," there is no basis to presume that any or every nonconformance must be the product of improper activity as should be subject to an IG disclosure.

Similarly, while the discovery of a counterfeit electronic part by a contractor subject to the DFARS does not, per se, trigger an IG disclosure, the outcome would be different if the contractor discovered that its employees violated the companies' counterfeit avoidance policies or engaged in willful or reckless disregard of these policies.

Those who drafted the DFARS plainly recognize this point, as the promulgation comments include the following statement:

Although DoD recognizes the importance of the 'mandatory disclosure' rules, this may not be an appropriate use of them because it suggests a contractor has committed an 'ethical or code of conduct violation.'

79 Fed. Reg. 26103. Stone's comments, about the role of the IG in receiving contractor disclosures of counterfeit electronic parts, are not in sync with the thinking of those other DOD officials who drafted the DFARS. Further coordination among DOD components seems needed.

A contractor disclosure to the IG program often, if not usually, is followed by an investigation of the disclosing contractor. That would not be justified where the contractor's system, to detect and avoid counterfeit electronic parts, worked as intended. It would be wrong to burden reporting contractors, in such circumstances, with the expense of this additional disclosure.

In any event, both Section 818 and the DFARS call for disclosures using GIDEP and to the contracting officer, but not to the IG. Through either or both of those vehicles, the government will be informed and law enforcement can be involved, based on that disclosure, to go after the true culprit. The IG can be informed through GIDEP or by referral from contracting officers who receive contractor reports. For law enforcement, the U.S. Department of Justice may take the lead, as it has in past examples of prosecutions of sources of counterfeit electronic parts. Section 818 strengthened the criminal and civil penalties that the DOJ can seek from those who traffic in counterfeit electronic parts that may be used in military products or services.

The DOD IG could do the contractor community a great service by adjusting its publicly stated position to recognize that there is no present statutory or regulatory basis to compel disclosure of identified counterfeit parts or product nonconformance except in the limited circumstances where a company subject to the disclosure obligation has credible evidence that there has been a violation of federal criminal law involving fraud or a violation of the False Claims Act. This would cause the IG's position to conform to FAR 52.203-13 and to DFARS 252.246-7007.

—By Robert S. Metzger, Rogers Joseph O'Donnell PC

Robert Metzger is the head of the Washington, D.C., office of Rogers Joseph O'Donnell. He is the vice chairman of TechAmerica's Supply Chain Assurance Subcommittee.