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

What To Expect Under DOD's Counterfeit Parts Rule

Law360, New York (August 15, 2013, 11:57 AM ET) -- The U.S. Department of Defense has recently issued a proposed rule to combat the counterfeit electronic parts. Trying to preempt justifiable concerns on the part of small businesses at all tiers of the government contracts supply chain, the DOD indicated that "the impact should be negligible as long as the small entity is not supplying counterfeit parts to the prime contractor." That really understates the nature and scope of the impact to subcontractors and suppliers under this proposal.

The proposed rule would require prime contractors (that are subject to the Cost Accounting Standards) to implement an entirely new avoidance and detection scheme within their purchasing system, which would undoubtedly impact subcontractors and suppliers all the way down the supply chain — big and small, counterfeiters and noncounterfeiters alike.

I attended the public meeting on this proposed rule on June 28, where these concerns were aired to representatives of the Defense Procurement and Acquisition Policy (DPAP) office and the Defense Contract Management Agency (DCMA). What follows is an analysis of some of the key points of concern for small businesses and suppliers coming from the meeting and the proposed rule.

Trusted Suppliers

The proposed rule would require that CAS-covered contractors modify their purchasing systems to incorporate the "use and qualification of trusted suppliers." But what is a trusted supplier? The rule provides no answer. And even if it did, what would be the legal effect of using a trusted supplier?

Under the proposed rule, a contractor would seemingly not avoid liability by using a qualified, trusted supplier. Instead, the cost of counterfeit parts — or the rework/corrective action needed to remedy their use — is expressly denied in all cases. It is a strict liability regime, with several very narrow exceptions. Understandably, therefore, every representative of the electronic parts industry at the June 28 meeting asked that the final rule clarify the meaning of "trusted suppliers."

The industry's concerns may be eased in part by a recent development in the House of Representatives. On June 7, the House Armed Services Committee reported out a version of the National Defense Authorization Act for fiscal year 2014 that would curtail liability for contractors "if the counterfeit electronic parts were procured from an original manufacturer or its authorized dealer, or from a trusted supplier."

Thus, the House would give some effect to the proposed rule's mandated use of trusted suppliers. This also reflects the sort of "risk-based" approach to detection and avoidance of counterfeit parts, which industry has consistently urged in lieu of the "zero-tolerance" approach evidence by the current version of the rule.

The problem, of course, is that 'trusted supplier' is still left undefined. Absent some standard definition, contractors will have no way of knowing whether their own internal processes or industry standards would "qualify" trusted suppliers. The consequence of that uncertainty will surely be to increase costs for all involved.

Even assuming that a standard definition is necessary, however, it need not necessarily come from government. At the June 28 meeting, representatives from DPAP evinced a willingness to adopt industry standards where possible. For example, a representative of DPAP suggested that another proposed rule, FAR Case 2012-032 (Higher-Level Contract Quality Requirements), would expressly invoke established industry standards. Given this apparent willingness to accept industry definitions, the final rule might ultimately reflect a private sector approach to identifying trusted suppliers. This remains to be seen.

Flow-Down Requirement

The prime contractor's new avoidance and detection system will have to satisfy nine criteria, the last of which is particularly pertinent here: "The flow down of counterfeit avoidance and detection requirements to subcontractors." So any suggestion that the impact will be limited to prime contractors can be dismissed out of hand. Instead, subcontractors and suppliers can expect the primes to insist upon some or all of the controls applicable to the prime contractors.

The problem, just as with the trusted suppliers issue, is a lack of uniformity. There is no standard flow-down provision included with the proposed rule. This compounds the uncertainty issues raised above: If the prime contractor does not know exactly what its obligations are under the rule, how will it know what to flow down? A tendency to "err on the safe side" might mean substantial — and unwarranted — costs for subcontractors, prime contractors, and the government. This concern, too, was raised numerous times at the June 28 meeting.

Suspect Counterfeit Parts

Finally, there is significant and justifiable concern over the disallowance for costs associated with even suspect counterfeit parts. To be clear, under the proposed rule, a contractor's costs may be disallowed for a suspected counterfeit part — even if that part is in fact authentic. All an inspector needs is "reason to believe that a part may be a counterfeit part." This is an enormous grant of discretion to contracting officers and their representatives. As industry representatives pointed out at the June 28 meeting, many electronic parts spend years on the shelf and in transit. The resultant wear and tear may suggest a counterfeit upon "visual inspection," even though the part is perfectly authentic.

Apart from the legal issues of ambiguity and discretion, the disallowance for suspect counterfeit parts is sure to have economic consequences. Because prime contractors and subcontractors are responsible for detecting and avoiding parts that are suspected to be counterfeit, we can dispense with any pretense that the impact would only be felt by the actual counterfeiters — as the rule's preamble suggests — or by those who actually purchase counterfeit parts. Instead, virtually any subcontractor or supplier can fall victim to disallowance and withholding, and they will necessarily build the risk of such consequences into their cost structures.

Conclusion

All this begs the question: Is it worth it? Many have suggested moving toward a risk-based, vice zero-tolerance, approach to avoidance and detection. From a recognition that 100 percent avoidance is impossible, the argument goes, comes the flexibility to avoid the necessary increase in costs described above while still giving contractors the financial incentive to weed out truly counterfeit parts. What balance will the final rule strike?

--By Jason Lynch and Peter J. Eyre, Crowell & Moring LLP

Jason Lynch is an associate in Crowell & Moring's Washington, D.C., office and a member of both the government contracts and white collar practice groups. Peter Eyre is a partner in the firm's government contracts group in Washington.