

ALERT

DOD Releases Long-Awaited Proposed Rule on Counterfeit Electronic Parts

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On Thursday, May 16, the Department of Defense (DOD) issued a proposed rule that implements Section 818 of the 2012 National Defense Authorization Act (NDAA) and Section 833 of the 2013 NDAA, which would impose new and potentially costly burdens on DOD contractors to detect and avoid counterfeit electronic parts. See 78 Fed. Reg. 28,780 (May 16, 2013). The proposed rule would modify the Defense Federal Acquisition Regulation Supplement (DFARS) to require many contractors to implement counterfeit electronic part detection systems as part of their approved purchasing systems. In addition, in most cases the proposed rule would make the costs of counterfeit parts and any associated rework or corrective actions unallowable.

As discussed below, the proposed rule potentially poses challenges to government contractors. Although the proposed rule would apply directly only to DOD contractors that perform contracts for supply of electronic parts or products that are subject to the Cost Accounting Standards (CAS), its obligations and costs would likely cascade throughout the DOD electronic parts supply chain. The proposed rule also defines expansively—and potentially ambiguously—what would constitute “counterfeit parts,” which may even impact *bona fide* manufacturers and suppliers.

Scope of the Proposed Rule. The proposed rule would apply directly to all “contractors that are subject to [CAS] . . . and that supply electronic parts or products that include electronic parts under CAS-covered contracts.” For these CAS-covered contracts, the covered contractors would be responsible “for detecting and avoiding the use or inclusion of counterfeit electronic parts or suspect counterfeit electronic parts” and “for any rework or corrective action that may be

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required to remedy the use or inclusion of such parts.”

The proposed rule would implement the new requirements for a counterfeit parts detection and avoidance system through a new DFARS contract clause 252.246-70XX that would be inserted in CAS-covered contracts for electronic parts or products. The DFARS requirements for an acceptable contractor purchasing system would also be revised to require compliance with DFARS clause 252.246-70XX. Among other requirements, the proposed clause would require contractors’ systems to address the following minimum elements:

1. Personnel training;
2. Inspection and testing of electronic parts, including criteria for acceptance and rejection;
3. Mechanisms to trace parts to suppliers;
4. Use and qualification of trusted suppliers;
5. Reporting and quarantining of counterfeit electronic parts and suspect counterfeit electronic parts;
6. Methodologies to identify suspect electronic parts and to rapidly determine if a suspect electronic part is, in fact, counterfeit; and
7. Flowdown of counterfeit avoidance and detection requirements to subcontractors.

By incorporating counterfeit parts detection into a contractor’s approved purchasing system requirements, the proposed rule also allows contracting officers to withhold payments if the system fails to meet these requirements. *See, e.g.,* DFARS 252.244-7001.

Although both the detection and avoidance and the purchasing system contract clauses would apply only to contractors with relevant CAS-covered contracts, which DOD stressed in the preamble to the proposed rule, the practical impact of the proposed rule could be far broader. For example, the proposed requirement for a contractor’s approved counterfeit parts detection system to flow counterfeit detection and avoidance procedures down to subcontractors, or to utilize “trusted suppliers,” means that the proposed rule could impact contractors of all sizes throughout the DOD electronic parts supply chain. DOD attempted to downplay the potential impact to small businesses in the supply chain, suggesting that “[t]he impact should be negligible as long as the small entity is not supplying counterfeit electronic parts to the prime contractor.” In cases where small businesses serve as distributors or resellers or incorporate third-party electronic parts into new components or systems, however, these businesses could still be impacted by the proposed rule’s flowdown requirement or by similar requirements placed in them by prime contractors to become “trusted suppliers.” Furthermore, while the rule would impose the purchasing system requirements on only CAS-covered contracts, once prime contractors incorporate counterfeit electronic parts detection processes into their approved purchasing systems, those processes would likely be deployed throughout the prime contractor’s enterprise, including on contracts that are not CAS-covered.

Definitions. The proposed rule also includes new and expansive definitions for key terms, including “counterfeit electronic part,” “suspect counterfeit electronic part” and “legally authorized source.” One significant development in the proposed rule is the broad definition of “counterfeit parts” to which the rule would apply:

1. "An unauthorized copy or substitute part that has been identified, marked, and/or altered by a source other than the part's legally authorized source and has been misrepresented to be from a legally authorized source";
2. "An item misrepresented to be an authorized item of the legally authorized source"; or
3. "A new, used, 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."

Although the first two categories are consistent with definitions previously included in DOD Instruction 4140.67, DOD Counterfeit Prevention Policy, and commonly associated in industry with counterfeits, the third category would significantly expand the scope of "counterfeit parts."

For example, the proposed rule does not clarify what would constitute a "misrepresentation" under the rule. Arguably, the rule could be interpreted to include unintentional "misrepresentations" about an electronic component's capabilities, latent design or manufacturing defects, or other errors that would typically be covered under standard warranty provisions. Furthermore, the proposed rule does not clarify how the "performance requirements for the intended use" would be measured, or whether the term refers to the performance specifications for the electronic part established by the manufacturer, or the performance requirements of an end item or system into which the electronic part will be installed.

Restrictions on Allowable Costs. Finally, the proposed rule would shift to contractors the risk and cost of most counterfeit parts that are introduced to the DOD supply chain, consistent with the instruction in Section 818. The proposed rule would include a new subsection of the DFARS allowable cost procedures that would make "expressly unallowable" the "costs of counterfeit electronic parts or suspect counterfeit electronic parts," as well as the additional "cost of rework or corrective action" when counterfeits are improperly introduced to the supply chain or utilized in DOD systems. The proposed rule includes a limited safe harbor exception that would apply in cases where the counterfeit electronic parts are Government-furnished property, but in all other cases the potential unallowable costs associated with counterfeit parts, "rework" and "corrective action" could be significant—even if the contractor maintains robust purchasing system counterfeit electronic parts detection processes.

Conclusion and Outlook. Many aspects of the proposed rule implement legislation from the 2012 and 2013 NDAA's, and therefore reflect an unavoidable shift in allocation to contractors of the costs and risks of counterfeit electronic parts detection and prevention in the DOD supply chain. Contractors should actively monitor the status of the proposed rule, and may consider submitting comments, which are due July 15, 2013.