

EXPERT ANALYSIS

Government Contracts: Holding Contractors Accountable for the Supply Chain

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Federal agencies are increasingly interested in the sourcing of contractors' goods. As a result, contractors are seeing scrutiny of their supply chains under existing regulations —and they can expect more in the coming year as new rules take hold.

In general, federal regulations put the burden of compliance on prime contractors, making them responsible for the actions of their suppliers and subcontractors. That can create problems under, among other things, the Trade Agreements Act of 1979 (TAA). The TAA requires that products sold to the U.S. government be manufactured in the U.S. or a country that has favored trade status with the U.S. And that can lead to complications in an era of global business.

Many companies have moved manufacturing offshore, often to countries that are not designated countries under the TAA. In the pharmaceutical industry, for example, key ingredients are often made in India and China. The Food and Drug Administration (FDA) certifies manufacturing operations in those countries, but there is confusion on the part of manufacturers when those FDA-approved drugs cannot be sold to the U.S. government because of the country where they were manufactured.

Today, contractors are coming under increased scrutiny for TAA compliance — in part because whistleblowers have a strong financial incentive to report violations and initiate qui tam lawsuits under the False Claims Act (FCA). Government agencies have been investigating potential violations with more frequency, and the Department of Justice (DOJ) is increasing its use of the FCA as a TAA enforcement tool.

In April 2015, for example, medical device company Medtronic agreed to pay the federal government \$4.41 million to resolve allegations that it violated the FCA by making false statements about the country of origin for products it sold to government agencies. The devices were actually made in China and Malaysia, which are prohibited countries under the TAA.

The government is taking a strong interest in where the products it buys are coming from. Agencies are showing an increased interest in the quality of goods as well. For example, contractors now need to comply with the Department of Defense's (DOD) counterfeit electronic parts rule. The rule was released in 2014, and the Defense Contract Management Agency, which oversees implementation, provided guidance in July 2015.

Under the rule, contractors need to implement systems to detect counterfeit electronic parts, and these systems will be reviewed in government audits of contractor purchasing systems. If a contractor does not have an acceptable system, its purchasing system may be disapproved and payments may be withheld by the DOD. If counterfeit parts make their way to the DOD, they may be rejected, with the cost of any repair or corrective action to be picked up by the contractor.

Similarly, contractors need to keep an eye on proposed changes to the Federal Acquisition Regulation that would require more extensive reporting of suspected counterfeit or defective parts.



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Under these changes, contractors would have to report such parts to a central database — the Government-Industry Data Exchange Program — and check that database before purchasing parts from suppliers. The rule, which is expected to be finalized in 2016, would go further than the DOD's rule and include all parts, not just electronic components.

Complying with this growing range of regulations will require changes to contractors' practices and capabilities. In a very real sense, contractors are only as compliant as their supply chain. But in order to comply, there needs to be visibility far down the supply chain to some very small, minor subassemblies and components. It's imperative to understand where products are coming from if you are planning on selling to the government.

What's more, some agencies have started to push for action beyond the written regulations. They are taking an aggressive position, with the expectation that contractors will actively monitor their subcontractors for compliance, not just have them certify that they are in compliance. That is raising new questions about the role that prime contractors will play in overseeing their suppliers.

These trends will present challenges and create risks ranging from fines to suspension and debarment — and unwanted publicity. The changing landscape offers opportunity as well. Like contractors, federal agencies often struggle to keep track of changing regulations and requirements. They see value in companies that keep up to speed on these things. The companies that understand these regulations — and not only know the rules but also know how to best demonstrate compliance — will have a competitive advantage in working with the federal government.



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