

DOD Counterfeit Parts Rule Signals Tough Enforcement

By **Dietrich Knauth**

Law360, New York (May 06, 2014, 4:53 PM ET) -- The U.S. Department of Defense issued a final rule Tuesday intended to remove counterfeit electronic parts from its supply chain, taking a tough stance on high-risk electronics and resisting contractor calls for commercial exemptions that could have blunted the rule's costs for the defense industry.

The DOD rule, proposed in May 2013, requires defense contractors to scour their supply lines for counterfeit electronics, which pose greater risk of failure and sabotage, and it puts contractors on the hook for the costs of replacing any counterfeits that make their way into DOD weapons systems. Contractors have worried that the regulation will cause financial harm and that expensive anti-counterfeit testing and vetting procedures will force some companies out of the DOD supply chain entirely.

The DOD's final version of the rule refines its approach in response to contractor criticism, but it does little to ease those larger fears. Although some contractors were hoping for a carveout for commonly sold commercial items, the DOD clarified the regulation to make clear that subcontractors that supply off-the-shelf technology to covered contractors must adhere to the new anti-counterfeiting requirements.

"DOD is very serious about the integrity of the supply chain and they recognize that carving out off the shelf items leaves a gap in their coverage," said Peter Eyre of Crowell & Moring LLP. "The final rule demonstrates that DOD expects visibility and coverage from top-to-bottom of the supply chain."

In its response to comments seeking an exemption, the DOD said that it will apply the rule "without regard to whether the purchased part is a commercial or [commercial off-the-shelf] item," adding that "studies have shown that a large proportion of proven counterfeit parts were initially purchased as commercial or COTS items."

By using "flowdown" clauses in subcontracts, the DOD is hoping to spread the costs of the rule throughout its industrial base and enlist more companies in the fight against counterfeits.

"The prime contractor cannot bear all responsibility for preventing the introduction of counterfeit parts," the rule said. "By flowing down the prohibitions against counterfeit and suspect counterfeit electronic items and the requirements for systems to detect such parts ... there will be checks instituted at multiple levels within the supply chain, reducing the opportunities for counterfeit parts to slip through into end items."

The DOD revised some terms in the proposed rule, tightening the focus on counterfeit electronics and easing some concerns that broad wording in the proposed rule would greatly expand the contractors' responsibilities.

The DOD dropped the term "counterfeit part" from proposed regulations and replaced it with "counterfeit electronic part," with a new and more detailed description, which will better focus contractors' anti-counterfeiting efforts on high-risk electronics. It also made clear that its definition of "counterfeit" requires intentional misrepresentation of a part's authenticity, which should keep the rule from expanding liability for defective parts, according to Jon Burd, a partner at Wiley Rein LLP.

"The proposed rule could have unwittingly swept up authentic parts that may have been defective for one reason or another," Burd said. "Now, we don't run the risk that run-of-the-mill defects will be swept up in the definition of counterfeits."

The rule also introduces the concept of "credible evidence" related to counterfeit parts, and it makes it clear that the DOD expects contractors to take a risk-based approach to additional testing. The DOD will not demand that contractors exhaustively test every part as soon as questions are raised about their authenticity, acknowledging that it is "not practical or cost effective to test in every case of a suspected counterfeit."

"DOD's not trying to reinvent the wheel here; they're just trying to tighten up their supply chain," Burd said. "While there's no doubt that this is going to impose new burdens on the industry, at least DOD is allowing some flexibility in how contractors approach their new responsibilities."

Contractors are already familiar with the credible evidence standard as a result of the mandatory disclosure rule, which requires contractors to investigate and report "credible evidence" of fraud or significant governmental overpayments. That approach, which allows contractors time to investigate during their 60-day window for reporting counterfeits, could delay the "trigger point" at which the rules disallow contractor costs, according to Christopher Myers of McKenna Long & Aldridge LLP.

"It opens the possibility that some investigatory costs could be allowable, if the part turns out to be authentic," Myers said.

Although the revised definitions and the new risk-based approach will likely help contractors, they will probably need new legislation to address their biggest concern: the lack of a safe harbor for the costs of replacing counterfeit electronics that make it into a DOD weapons system despite a contractor's best efforts. The current safe harbor, which was added in the 2014 National Defense Authorization Act, allows contractors to recoup such costs only when the suspect or counterfeit parts are actually provided by the government.

Contractors had suggested adding exemptions for counterfeits that are purchased from the original manufacturer or an authorized reseller, counterfeits that are introduced by "an overt criminal enterprise or the work of a foreign intelligence attack" or for old parts that are no longer manufactured or supplied by authorized dealers. But the current legislative language "does not allow for the additional exemptions or carveouts as suggested by respondents," the final rule said.

Congress may be open to expanding that safe harbor to contractors that have DOD-approved systems for counterfeit detection, Myers said, noting that the House Science, Space and Technology Committee

included a broader safe harbor for counterfeit electronics in its 2015 NASA authorization bill.

In the near term, the new regulation will affect a wide range of players that sell within the defense industry. The DOD acknowledged that the rule will affect businesses, including small businesses, that are not directly covered by the rule, but it noted that most businesses that sell electronic components are "well aware" of their responsibility to sell authentic parts and should already have systems in place to protect them and their customers from counterfeits.

Although many of the largest and most sophisticated defense contractors have already tried to get a head start on compliance with the rule, smaller defense contractors and commercial information technology companies with complicated supply chains will have to quickly ensure that they have adequate systems to track their electronic parts and processes to detect and avoid counterfeits.

"In particular, companies with a large, dispersed, or complex supply chain should be paying careful attention to this rule," Eyre said. "Commercial item contractors providing electronic components should expect the flow-down clause, and it makes sense to conduct a risk analysis and begin enhancing systems and programs to track the mandatory elements contained in the final rule."

Attorneys worry that the rule, along with others, could shrink the DOD's supplier base and make some companies consider getting out of the defense business rather than take on the additional costs, regulations and risks.

"There is some potential that more companies will make a business decision that it's not worth it to get into government contracting, because there is a new and pretty onerous requirement with regard to counterfeit parts," Myers said.

The changes to the rule are significant, and contractors will have to take time to study the new requirements. But they will have to quickly prepare for implementation, without the chance to weigh in on the DOD's changes.

"I'm surprised that they elected to move forward with a final rule rather than issuing an additional interim final rule with the possibility for additional comment, given the scope of the changes they made to the rule," Burd said. "These would have been the kinds of changes that would have lent themselves to additional industry comment."

--Editing by Jeremy Barker and Katherine Rautenberg.