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FEATURE COMMENT: Proposed FAR Rule Looks To Expand Reporting Of Nonconforming Items

On June 10, the Federal Acquisition Regulatory Council issued a proposed rule in Federal Acquisition Regulation Case 2013-002, Expanded Reporting of Nonconforming Items. 79 Fed. Reg. 33164–68 (June 10, 2014). Although counterfeit electronic parts have received a great deal of attention from Congress and regulators, the proposed rule would extend counterfeit regulations to other types of items and materials.

Under the proposed rule, virtually all contractors, including commercial-item and small business contractors, would be required to report counterfeit and nonconforming items and materials they find in their supply chains when those items could lead to certain types of harm. As stated in the rule's preamble, "the problem of counterfeit and nonconforming parts extends far beyond electronic parts and can impact the mission of all Government agencies." This FEATURE COMMENT summarizes the statutes and regulations that preceded the proposed rule, summarizes the proposed rule's contents, and explains how the rule affects Government contractors.

Section 818 of the 2012 NDAA and Regulatory Action to Date—As noted in the preamble to the proposed rule, a number of policy organizations have determined that counterfeit parts in the supply chain for items that the U.S. Government procures is a significant problem:

The [Senate Armed Services Committee] reported in 2011 that [over a two-year period] it had identified 1,800 cases of counterfeiting, comprising roughly one million parts. The

[Department of Commerce] reported in 2010 that 9,356 suspected cases of counterfeiting had been identified in the defense industrial supply chain in 2008, an almost three-fold increase since 2005. [Government-Industry Data Exchange Program (GIDEP)] data also supports an increase over the past decade in counterfeit components and assemblies used in the Government.

79 Fed. Reg. 33164 (June 10, 2014). Such findings led to the National Defense Authorization Act for Fiscal Year 2012, P.L. 112-81, which, in § 818, required the secretary of defense to take certain measures to eliminate counterfeit electronic parts from the Department of Defense supply chain, by, among other things, (1) establishing definitions of "counterfeit electronic part" and "suspect counterfeit electronic part," (2) providing guidance for a risk-based approach to prevent entry of counterfeit parts into the defense procurement supply chain, and (3) establishing reporting requirements for any actual or suspected counterfeit parts that make their way into the supply chain.

As part of its effort to meet the NDAA's mandates, DOD promulgated a new Defense FAR Supplement clause 252.246-7007, requiring certain contractors to "establish and maintain [] acceptable counterfeit electronic part detection and avoidance system[s]." This clause applies to contractors subject to the Cost Accounting Standards, including both full and modified CAS coverage.

In addition, DOD added DFARS 252.244-7001, providing that assessment of counterfeit electronic part detection and avoidance systems is an additional step the Defense Contract Management Agency will complete when performing contractor purchasing system reviews (CPSRs). Failure to maintain acceptable counterfeit electronic part detection and avoidance systems may cause disapproval of contractors' purchasing systems, thereby placing the contractors' eligibility to perform contracts at risk. This DFARS clause applies only to DOD contractors and counterfeit electronic parts, and it is hewed closely to

§ 818’s express requirements. The FAR Council, however, has initiated a more expansive implementation of § 818: the proposed rule.

Proposed Rule on Expanded Reporting of Nonconforming Parts—The FAR Council determined that the previously discussed DFARS rule was not, by itself, sufficient to address the problem of counterfeit parts. “While Section 818 applied only to DOD, only to electronic products, and only to contractors covered by the Cost Accounting Standards [], the FAR Council concluded that the principles expressed in Section 818 should be applied beyond DOD, should not be limited to electronic products, and should not be limited to CAS-covered contractors.” Furthermore, while an Office of Federal Procurement Policy letter, Policy Letter 91-3, requires *agencies* to report to GIDEP, the FAR Council believes that the timeliness and effectiveness of the reporting will be enhanced if *contractors* report directly to GIDEP.

The proposed rule is intended to mitigate the growing threat to an agency’s mission and vital systems that counterfeit items in a global supply chain pose. Accordingly, the proposed rule would reduce the risks by ensuring that contractors timely report suspect items in a widely available database. The following discussion outlines how the proposed rule would extend counterfeit prevention efforts beyond counterfeit electronic parts and CAS-covered DOD contractors.

Definitions: The proposed rule defines certain key terms. “Common item” is a “material that is common to the applicable Government contract and the contractor’s other work, except ... for use in [FAR] part 46.” The phrase “counterfeit item” refers to “an unlawful or unauthorized reproduction, substitution, or alteration that has been knowingly mismarked, misidentified, or otherwise misrepresented to be an authentic, unmodified item from the original manufacturer, or a source with the express written authority of the original manufacturer or design activity, including an authorized aftermarket manufacturer.” “Quality escape” refers to “a situation in which a supplier’s internal quality control system fails to identify and contain a nonconforming condition.”

A “suspect counterfeit item” is “an item for which credible evidence (including but not limited to, visual inspection or testing) provides reasonable doubt that the item is authentic.” The FAR Council noted that “critical nonconformance” is already defined at FAR 46.101 as a nonconformance that is likely to result in hazardous or unsafe conditions for individuals using,

maintaining or depending on the supplies or services; or that is likely to prevent performance of a vital agency mission. Likewise, “major nonconformance” also is already defined at FAR 46.101 as a nonconformance that is not critical, but is likely to result in failure of the supplies or services, or materially reduce the usability of the supplies or services for their intended purpose.

Scope: The proposed rule would add a number of requirements to any contracts for supplies that are (a) delivered to the Government, (b) acquired by the contractor for use in performing services, or (c) furnished by the contractor for use by the Government.

The proposed rule would require contracting officers to describe during acquisition planning how they plan to administer a contract with respect to inspection and acceptance (for services) and with respect to the risk-based Government quality assurance measures used to identify and control major and critical nonconformances, including use of GIDEP (for supplies). In addition to imposing this obligation on COs, the proposed rule provides that any contractor performing a contract involving supplies (including contracts that mainly involve services, but also that include some ancillary supplies), must use GIDEP to report counterfeits or suspected counterfeits as explained in more detail below.

The proposed rule includes ensuring that vendors or suppliers of raw or processed materials, parts, components, subassemblies, and finished assemblies have acceptable quality control systems in a list of “contractor responsibilities,” but the rule does not explain exactly what contractors must do to monitor or verify their suppliers’ quality control systems. Contractors must further ensure that any quality escapes of their vendors are not incorporated into the contractors’ products.

The proposed rule is intended to build on a contractor’s current quality and inspection system, and it demonstrates the link between a supplier’s quality control system and preventing quality escapes from being incorporated into the supply chain. While the FAR Council recognizes that even the best quality system will fail to detect a small percentage of nonconformances, it also stated that ensuring that quality and inspection systems work as well as they possibly can is the “pivotal issue justifying mandatory GIDEP reporting.”

Reporting: The proposed rule would require contractors to monitor or “screen” GIDEP for any

counterfeits that other manufacturers have reported and that might affect the contractors' products. In addition, contractors must make certain reports related to counterfeit items, including:

- reports to COs within 30 days after a contractor becomes aware that any end item, component, subassembly, part or material contained in supplies purchased by the contractor for delivery to or for the Government is counterfeit or suspect counterfeit (contractors that make these reports and have the items in their possession must retain the items until they receive disposition instructions from the Government); and
- reports to GIDEP within 60 days after the contractor becomes aware that an item purchased by or for the contractor for delivery to or for the Government is counterfeit or suspect counterfeit or contains a major or critical nonconformance that is a common item and constitutes a quality escape that has resulted in the release of like nonconforming items to more than one customer.

The proposed rule will add a new clause at 52.246-XX, Reporting Nonconforming Items, which shall be included in solicitations and contracts for the acquisition of supplies or services that include supplies, and that are (a) delivered to the Government, (b) acquired by the contractor for use in performing services, or (c) furnished by the contractor for use by or for the Government. The clause will allow the CO to modify paragraph (c), but only to shift responsibility for GIDEP reporting from the contractor to the CO.

There is a key distinction between circumstances requiring reporting to a CO and circumstances requiring reporting to GIDEP. The CO need not be notified if the contractor identifies a major or critical nonconformance and rectifies the nonconformance prior to delivery. Conversely, the CO *must* be notified if a counterfeit or suspect counterfeit item is identified, regardless of whether the contract rectifies the nonconformance prior to delivery.

Following notification, the CO will provide disposition instructions for the counterfeit or suspect counterfeit item. In some cases, agency policy will require the CO to instruct the contractor's retention of the counterfeit or suspect counterfeit item for investigative or evidentiary purposes.

To summarize the new reporting requirements, the proposed rule contains several conditions that

must exist that mandate a GIDEP report: an item (1) must be a counterfeit or suspect counterfeit item, or (2) contain a major or critical nonconformance that is a common item, and (3) that constitutes a quality escape from a lower-level subcontractor or supplier, which (4) results in the release of nonconforming items to more than one customer.

Limited Safe Harbor: The proposed rule would implement one "safe harbor" for DOD contractors that make nonconformance reports for electronic components. For DOD contracts, contractors or subcontractors that provide written reports or notifications under the proposed rule's new contract clause would not be subject to "civil liability on the basis of such reporting, provided that the contractors or subcontractors made a reasonable effort to determine that the end item, component, part, or material contained electronic parts that were counterfeit items or suspect counterfeit items." In other words, contractors subject to the DFARS rule would not face civil liability when they acknowledge counterfeits in their supply chains by submitting nonconforming item reports under the proposed rule.

Flow Down: The proposed rule's contract clause would be required in "all subcontracts for supplies, or services that include supplies, at any tier." Contractors would be responsible for ensuring that vendors and suppliers of raw or processed materials, parts, components, subassemblies, and finished assemblies have an acceptable quality control system to prevent quality escapes at the vendor or supplier tier from being incorporated into the contractor's final product.

Commercial-Item Acquisitions: The proposed rule would amend FAR 12.208 to add a sentence at the end of the paragraph stating that for "supply contracts and service contracts that include supplies, contractors shall be required to use [GIDEP]."

How the Proposed Rule Would Affect Contractors—The FAR Council downplayed the notion that the proposed rule would introduce any sort of "sea change." The FAR Council stated that the terms "are familiar to the quality assurance and contracting workforces and have been in use for decades." However, it seems likely that commercial-item and small business contractors would need to establish internal procedures for monitoring GIDEP and the parts they receive, and implement training to ensure employees are equipped to follow those procedures. In other words, the proposed rule could create a significant compliance burden, particularly for small- and medium-sized contractors.

What's Next: Comment Period and Beyond—

Comments on the proposed rule are due by August 11. Specific areas in which the FAR Council is seeking comments include: (a) whether the expanded nonconforming parts reporting is necessary for the proper performance of functions of the FAR and will have practical utility; (b) whether the FAR Council's estimate of the public burden of this collection of information is accurate and relies on valid assumptions and methodology; and (c) ways in which the FAR Council can minimize the burden of the collection of information on those who are to respond.

Thus far, a handful of contractors and trade associations have weighed in with comments on the proposed rule. Comments include criticism that the proposed rule overreaches, since the plain language of § 818 of the 2012 NDAA is limited to *electronic* parts. Moreover, § 818 expressly carved out a limited safe harbor from cost disallowance for Government-furnished counterfeit electronic parts, but the proposed rule does not include any similar safe harbor.

Commenters are also concerned that increased reporting to GIDEP could overwhelm the GIDEP system, and that the reporting burden the proposed rule would impose on contractors, particularly commercial-item contractors or small businesses, is excessive. Along the same lines, some commenters have suggested that nonconforming parts reporting rules should be codified in the DFARS, rather than the FAR, since § 818 focused only on defense contractors.

In the preamble to the proposed rule, the FAR Council took pains to provide a thorough rationale for extending the proposed rule to cover more contractors and more than just electronic parts, despite § 818's limits. This suggests that the Council anticipated complaints about extension of counterfeit requirements beyond electronic parts and has no plans to retract the proposed rule's reach. Beyond that, it remains to be seen whether other commenters will raise issues that prompt the FAR Council to modify the proposed rule. During a June 16 public meeting on the proposed rule, representatives from the FAR Council indicated that the process for the proposed rule has moved, and is moving, quickly, so we expect the Council will issue a final or interim rule not too long after the comment period closes on August 11.

Conclusion—In closing, contractors selling any tangible items to the Government should take note of the proposed rule, consider whether their products contain “common items” that could lead to “critical” or “major” nonconformances, and begin to assess what procedures and training they will need to implement to comply with new FAR provisions that reflect the proposed rule.



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