

Counterfeit Parts: Turning the Dial to Eleven

Written by Nick Sanders
Wednesday, 18 June 2014 00:00

Nigel Tufnel : The numbers all go to eleven. Look, right across the board, eleven, eleven, eleven and...

Marty DiBergi : Oh, I see. And most amps go up to ten?

Nigel Tufnel : Exactly.

Marty DiBergi : Does that mean it's louder? Is it any louder?

Nigel Tufnel : Well, it's one louder, isn't it? It's not ten. You see, most blokes, you know, will be playing at ten. You're on ten here, all the way up, all the way up, all the way up, you're on ten on your guitar. Where can you go from there? Where?

Marty DiBergi : I don't know.

Nigel Tufnel : Nowhere. Exactly. What we do is, if we need that extra push over the cliff, you know what we do?

Marty DiBergi : Put it up to eleven.

Nigel Tufnel : Eleven. Exactly. One louder.

Marty DiBergi : Why don't you make ten a little louder, make that the top number and make that a little louder?

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Nigel Tufnel : *[pauses]* [These go to eleven](#) .

The Government Contracts Attorneys at McKenna, Long & Aldridge summarized the situation with simple elegance. They wrote: "Contractors still assessing compliance with the DOD counterfeit electronic parts rule could soon be faced with another counterfeit parts obligation."

You remember the [DOD Counterfeit Electronic Parts rule](#) , don't you?

It was issued after the DOD Interim Rule covering " [supply chain risk](#) ." You know: that rule where contractors with secure supply chain systems would be subject to a statute-approved competitive advantage over those who did not. From our perspective, that rule was the carrot designed to entice contractors into moving into secure supply chains and product pedigree analysis.

Then DOD took the next step. It added requirements for a system to identify counterfeit electronic parts. DOD baked the new CEP requirements into the Purchasing System adequacy criteria and threatened to disapprove a contractor's purchasing system that failed to adequately address the new requirements. As we all know, a system disapproval in the DOD (or DOE) environment would lead to payment withholds that would impact cash flow. And DOD also said that the cost of rework or remedying inclusion of counterfeit electronic parts was likely to be unallowable, except in very specific circumstances. Those actions seemed like the sticks to us, designed to beat contractors who were not motivated by the carrot described above.

We figured that if the carrot didn't work, then sticks certainly would.

We figured the rulemakers had done their job and contractors would be moving in the desired direction.

And now the FAR Council has turned the dial to eleven.

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We're talking about FAR Case 2013-002, "Expanded Reporting of Nonconforming Items." Here's a link to [the proposed rule](#), which would revise the FAR (not just the DFARS) to require all government contractors to report not only counterfeit electronic parts, but also counterfeit parts of all types.

If adopted as proposed, the FAR rule will impose two fundamental requirements on government contractors:

1.

Ensure that vendors or suppliers of raw or processed materials, parts, components, subassemblies, and finished assemblies have an acceptable quality control system and that quality escapes from these vendors and suppliers are not incorporated into the contractor's final product; and

1.

Screen reports in the Government-Industry Data Exchange Program (GIDEP) to avoid the use and delivery of items that are counterfeit or suspect counterfeit items or that contain a major or critical nonconformance.

Contractors will be responsible for submitting a written report (a) to the Contracting Officer within 30 days, and (b) to the GIDEP within 60 days, when the contractor becomes aware of a counterfeit (or potentially counterfeit) part or if a quality escape deemed to be a critical or major nonconformance impacted a common item or more than one customer.

Clear?

Let's quote some proposed FAR definitions:

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Common item means an item that has multiple applications versus a single or peculiar application. Common items include, for example, raw or processed materials, parts, components, subassemblies, and finished assemblies that are commonly available products (such as nondevelopmental items, off-the-shelf items, National Stock Number items, or commercial catalog items).

Counterfeit item means 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. Unlawful or unauthorized substitution includes used items represented as new, or the false identification of grade, serial number, lot number, date code, or performance characteristics.

Critical nonconformance means a nonconformance that is likely to result in hazardous or unsafe conditions for individuals using, maintaining, or depending upon the supplies or services; or is likely to prevent performance of a vital agency mission.

Design activity means an organization, Government or contractor, that has responsibility for the design and configuration of an item, including the preparation or maintenance of design documents. Design activity could be the original organization, or an organization to which design responsibility has been transferred.

Major nonconformance means a nonconformance, other than critical, that is likely to result in failure of the supplies or services, or to materially reduce the usability of the supplies or services for their intended purpose.

Quality escape means a situation in which a supplier's internal quality control system fails to identify and contain a nonconforming condition.

Suspect counterfeit item means an item for which credible evidence (including but not limited to, visual inspection or testing) provides reasonable doubt that the item is authentic.

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The proposed rule would apply to primes and to subcontractors, to simplified acquisitions and to negotiated acquisitions, and to acquisitions of commercial items.

Interestingly, the new requirements are not being driven by Congress. That is to say, Congress did not direct the FAR Council to take the far-reaching rule-making actions that have been proposed.

Readers may recall [our analysis](#) of the FY 2012 NDAA, in which we noted Section 818, which required DOD to enhance its processes for detecting and avoiding counterfeit electronic parts. Let's let the FAR Council describe how they implemented that piece of statutory direction, courtesy of the Background section of the proposed rule. They wrote-

While section 818 applied only to DoD, only to electronic products, and only to contractors covered by the Cost Accounting Standards (CAS), 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. Similarly, although OFPP Policy Letter 91-3 requires agencies to report to the Government-Industry Data Exchange Program (GIDEP), the FAR Council determined that reporting would be much more timely and effective if contractors were to make the reports directly to GIDEP.

So there you have it. A new, potentially far-reaching, proposed rule driven not by statute but, instead, by the FAR Council's view of the seriousness of the threat.

But we're not done yet.

Perhaps the FAR Council is not wrong in its assessment of the situation.

On June 13, 2014, the Department of Justice [announced](#) that-

The former president of a Burlington, N.J.,-based defense contracting business was arrested

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and charged today ... Richard Melton, 44, of Moorestown, N.J., was charged by complaint with one count of conspiracy to commit wire fraud for receiving \$3 million from 2008 to 2009 as a result of allegedly fraudulent contracts with the U.S. Department of Defense (DoD).

Melton owned and operated Partz Network from April 2003 to December 2009. Partz Network contracted with the government to supply the DoD with parts on small-dollar contracts. The majority of the contracts were for replacement parts for military rolling stock: trucks, trailers, and engineering equipment. The majority of Partz Network's DoD contracts required that the items provided be manufactured by DoD-recognized qualified manufacturers. Melton and his conspirators allegedly lied on Partz Network's bids for DoD contracts, stating that they would be providing the "exact product" sought by the DoD, meaning that the product was manufactured by a DoD-recognized qualified manufacturer. In fact, Partz Network was allegedly providing parts made by unapproved, and oftentimes unknown, sources.

In 2007, the Defense Logistics Agency (DLA), a DoD contracting agency, became aware of reports of nonconforming parts being received from Partz Network. As a result, DLA required Partz Network to provide "traceability documents" to confirm that the items it was supplying were actually being manufactured by DoD-recognized qualified manufacturers. Partz Network provided traceability documents and invoices to DLA regarding items provided under the DoD contracts. When DLA researched the traceability documents supplied by Partz Network, DLA learned that the documents were either altered or completely fictitious. ...

The items ultimately provided by Partz Network were not the exact products required under the contract because the items were not manufactured by a qualified manufacturer. In fact, on Nov. 10, 2007, five days prior to Partz Network submitting its bid for the contract, Melton sent an e-mail to a Partz Network employee with a link to the DoD RFQ that stated the following: "Bid these (1400) HMMWW oil pans at \$53.85 and I will have them made overseas by [a company located in the People's Republic of China] or another overseas firm, 200-day lead time." Based on Partz Network documents related to that contract, Partz Network purchased the oil pans that were provided to the DoD from a company located in India in January 2008. ...

The wire fraud conspiracy count with which Melton is charged carries a maximum potential penalty of 20 years in prison and a fine of \$250,000, or twice the gain or loss from the offense.

So as long as the U.S. Government perceives the threat of non-conforming and/or counterfeit

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parts to be a serious threat, they would seem to be justified in requiring contractors to take measures to detect and deter their occurrence. The fact that it's going to impose new requirements (with additional costs) on contractors probably did not weigh heavily in the FAR Council deliberations. Perhaps with final implementation of this rule, there will be sufficient carrots and sticks available to reign in this practice.

On the other hand, when the U.S. Government keeps awarding contracts to the low-price bidder without regard to how those low prices were derived (e.g., outsourcing manufacturing to the People's Republic of China), it creates an incentive for contractors to keep breaking the rules. Note that the proposed rule would apply to both simplified acquisitions (Part 13) and commercial acquisitions (Part 12) as well as to negotiated acquisitions (Part 15). Price analysis is a significant aspect of Part 12 and Part 13 source selection decisions. It would not be uncommon for price to be the sole deciding factor between what seems to be otherwise responsible competing sources.

Moreover, it seems unrealistic to expect contractors to be motivated by regulatory carrots and sticks, when a threat of 20 years in Federal prison doesn't seem to affect behavior. The same people who would seek to defraud the Federal government prior to the implementation of this proposed rule would seem to still seek to defraud the Federal government, though of course there would be more certifications to falsify and more required reports to ignore. The same people who would ignore the Buy American Act and the Trade Agreements Act and the False Statements Act would not seem to be deterred by this new set of contractual requirements.

Consequently, one possible outcome of this proposed rule would be to increase the costs associated with the "good guys"-the compliant contractors who will do their best to meet their obligations ... while having no cost impact on the "bad guys" (those who intend to provide counterfeit or nonconforming parts regardless of the consequences). If this is the outcome, then the price disparity between the good guys and the bad guys is going to increase, leading to more awards to the bad guys.

Will this be the outcome? Only time will tell.