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FEATURE COMMENT: Final Rule Amending The FAR For Higher-Level Contract Quality Requirements

On November 25, the Federal Acquisition Regulatory Council issued a final rule clarifying when contracting officers must use higher-level quality standards in solicitations and contracts. 79 Fed. Reg. 70344–48, (Nov. 25, 2014). The final rule also updates examples of what constitute higher-level quality standards acceptable for use in the performance of a Government contract. Finally, the final rule removes from the Federal Acquisition Regulation obsolete standards and adds new industry standards that pertain to quality assurance for the avoidance of counterfeit and nonconforming items. The final rule becomes effective December 26.

The final rule applies to solicitations and contracts issued by the Department of Defense, the General Services Administration and NASA. This final rule follows the publication of the proposed rule on Dec. 3, 2013 that proposed revisions to FAR subpt. 46.2, Contract Quality Requirements. The proposed rule sought to ensure that Government agencies assess the risk of procuring nonconforming items and determine whether and when higher-level quality requirements and standards should be used in solicitations and contracts for the procurement of complex and critical items. Following the publication of the proposed rule, six respondents submitted comments. This FEATURE COMMENT analyzes the significant elements of the final rule.

The final rule is one of three final and proposed rules addressing various aspects of the detection and avoidance of counterfeit and nonconforming

items in the supply chain as required by § 818 of the National Defense Authorization Act (NDAA) for Fiscal Year 2012, P.L. 112-81. Section 818 follows the mandates published by the Senate Armed Services Committee (SASC) in its May 21, 2012 report memorializing the findings of the SASC's inquiry into counterfeit electronic parts in the DOD supply chain. Section 818 required the secretary of defense to take certain measures to eliminate counterfeit electronic parts from the DOD 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 systems. 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 that 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. See Vanek and Tibbets, "Counterfeit Electronic Parts—The DFARS Final Rule and The Expanded Reporting Requirements for Nonconforming Items," 14-11 BRIEFING PAPERS (Oct. 2014).

Unlike the DFARS clause on counterfeit electronic parts, this final rule is not limited to CAS-

covered contractors. This final rule applies to all contractors that supply complex and critical items to the Government, regardless of whether they are subject to modified or full CAS coverage.

On June 10 of this year, the FAR Council also issued a proposed rule covering contractor expanded reporting requirements on nonconforming items under Federal Acquisition Case 2013-002, Expanding Reporting of Nonconforming Items. 79 Fed. Reg. 33164–68 (June 10, 2014). This proposed rule is applicable to virtually all contractors, including commercial-item and small business contractors. Contractors would be required to expand their nonconforming obligations and report through the Government-Industry Data Exchange Program all counterfeit and nonconforming items and materials they find in their supply chains. See Vanek and Tibbets, Feature Comment, “Proposed FAR Rule Looks To Expand Reporting Of Nonconforming Items,” 56 GC ¶ 215.

Final Rule on Higher-Level Contract Quality Requirements—As noted by the FAR Council, this final rule does not directly implement any specific aspect or provision contained in § 818. However, this final rule recognizes the quality, reliability and safety risks that counterfeit items present to the overall procurement process and national security. Because of the globalization of the marketplace and procurement sources, the problem of counterfeits extends far beyond just DOD and electronic parts. Counterfeit and nonconforming items pose significant supply chain issues and challenges to both the Government and industry. The globalization of the marketplace dramatically increases the risk of counterfeit items entering the supply chain.

Definitions: Contract quality requirements, including contractor test and inspection obligations under a given contract, are typically based on the contract’s item or service classification as defined in the technical specifications, and by an item’s complexity and the criticality of the item’s end use. In determining the applicable higher-level contract quality requirements, the final rule relies on a number of existing FAR definitions promulgated at FAR subpt. 46.203, Criteria for Use of Contract Quality Requirements. “Complex” items “have quality characteristics not wholly visible in the end items, for which contractual conformance must be established progressively through precise measurements, tests, and controls applied during purchasing, manufacturing, performance, assembly, and functional operation

either as an individual item or in conjunction with other items.” By contrast “noncomplex” items “have quality characteristics which simple measurement and test of the end item are sufficient to determine conformance to contract requirements.”

The term “criticality” is defined as when the “application of an item is one in which the failure of the item could injure personnel or jeopardize a vital agency mission. A critical item may be either peculiar, meaning it has only one application, or common, meaning it has multiple applications.” By contrast a noncritical item or service is anything other than that which is defined by the FAR as critical, although noncritical items may be either peculiar or common.

Scope: The final rule adds a number of requirements that must be included in solicitations and contracts for items or services of a complex nature, and for items or services that perform a critical function. The final rule also removes obsolete FAR references to quality standards, removes quality standard SAE AS6174 referenced in the proposed rule, and includes, by way of example, higher-level quality standards applicable to overarching quality management systems. It is the obligation of the respective procuring agency to determine when higher-level quality standards are necessary to mitigate the risk, likelihood and impact of a nonconformance under the contracting activity.

The final rule imposes on the procuring agency the obligation to undertake a risk-based approach to determine the risk that nonconforming items present to the particular contracting activity. It is the responsibility of the procuring agency to inform its COs about which higher-level standards should be applied and included in the solicitation and contract. Generally speaking, the requirements of the higher-level quality standards applicable to the respective solicitation and ensuing contract are found in the technical specifications. The technical requirements will require (a) the control of such things as design, work operations, in-process controls, testing and inspection; or (b) attention to such factors as organization, planning, work instructions, documentation control and advanced metrology.

Examples of applicable higher-level quality standards are now promulgated in FAR subpt. 46.202-4(b). These higher-level quality standard examples are ISO9001, ANSI/ASQC E4, ASME NQA-1, SAE AS9100, SAE AS9003, and ISO/TS16949. Product- and process-specific quality standard SAE AS5553, applicable to counterfeit electronic parts, is

also included in the final rule. The FAR Council notes in the final rule's preamble that COs and technical personnel are not restricted to the foregoing list of higher-level quality standards. COs and technical personnel have the discretion to use other standards, provided those standards meet the Government's needs.

As now promulgated in FAR subpt. 46.311, the final rule mandates that the CO insert the revised contract clause at 52.246-11, Higher-Level Contract Quality Requirement, in solicitations and contracts when such inclusion is necessary. The CO is responsible for filling in the "title, number, date and tailoring (if any)" of the applicable higher-level quality standards. As noted, the CO has some latitude to tailor the language or requirements of a standard to fit the particular contracting activity. How much discretion and latitude is not defined in the final rule and is presumably left to interpretations under applicable agency procedures.

The final rule clearly notes that the objective is "to ensure the considered approach to the use of higher-level quality standards so they will not be applied indiscriminately." Moreover, existing agency procedures will provide guidance to the CO in determining when the use of higher-level quality standards is necessary and what standards are applicable to the contracting activity.

In the past, the contractor was able to select the appropriate or chosen quality standard applicable to the contractor's performance by ticking the appropriate block. The final rule eliminates contractor discretion. The previous option of allowing a contractor to choose which quality standards it would apply during contract performance was eliminated to ensure that the Government adequately assesses the necessity of the chosen higher-level quality standard and its appropriateness to the contract action. The FAR Council notes that this paradigm shift does not change a contractor's ability to work with the Government in determining which higher-level quality standards should be applied. Such Government-contractor interaction regarding the appropriate higher-level quality standards applicable to the contractor's performance should, taking into account procurement integrity requirements, occur prior to the receipt of proposals. This Government-contractor interaction can occur through "exchanges such as conferences, public hearings, one-on-one meetings, draft requests for proposals, etc."

As mentioned above, the final rule adds to FAR subpt. 46.202-4(b) different examples of higher-level quality standards already used by industry. These examples are intended to provide the procuring agency and its CO flexibility that best suits the technical and quality requirements of the contract. The standards included in FAR 46.202-4(b) are examples only and are not intended to be an exhaustive list of higher-level quality standards that could be incorporated into solicitations and contracts.

The list of higher-level quality standards incorporated into the final rule includes both overarching quality management system standards and product- and process-specific standards. These higher-level quality standards are common standards currently existing in industry. It is important to note that although the final rule did not create a comprehensive list of possible higher-level quality standards, the final rule similarly does not preclude the use of other industry standards not included in FAR 46.202-4(b).

In response to the growing concern about counterfeit electronic parts entering the supply chain and the associated risks in terms of quality, reliability and safety, the final rule adds to FAR subpt. 46.202-4(b) higher-level product- or process-specific quality standards specifically related to counterfeit electronic parts: SAE AS5553.

Per SAE International, the U.S.-based professional engineering and standards association, AS5553, first published in April 2009, is intended for use in aviation, space, defense and other high performance/reliability electronic equipment applications.

This standard is recommended for use by all contracting organizations that procure electronic parts, whether such parts are procured directly or integrated into electronic assemblies or equipment. The requirements of this standard are generic and intended to be applied [and] flowed down to all organizations that procure electronic parts, regardless of type, size, and product provided.

This standard was created and introduced to industry as a uniform means to mitigate the substantial threat counterfeit electronic parts pose to the supply chain.

While another common industry quality standard relating to counterfeit materials exists, SAE AS6174, it was not included in the final rule. Its deletion from the proposed rule follows the FAR Council's agreement with several commenters that this standard is

relatively new and does not provide adequate guidance to the Government and industry in implementing a meaningful counterfeit electronic parts detection and avoidance system.

Small Businesses: The final rule does *not* include an exemption for small businesses. DOD reasoned that in contracts for complex or critical items where higher-level quality standards are deemed necessary, “it is not prudent to make exceptions based on business size.” Therefore, any time the solicitation and contract contain one or more higher-level quality standards, businesses of any size are required to comply.

Flowdown: Consistent with the rationale that the final rule applies to businesses of any size, a prime contractor is required to flow down the applicable requirements of the relevant higher-level quality standards in all subcontracts that procure critical and complex items or services. This flowdown requirement is also consistent with the requirements found in many of industry’s higher-level quality standards. Those higher-level quality standards generally require contractors to apply the standards to their subcontractors.

Consequently, the final rule requires prime contractors to flow down to their subcontractors the requirements of the higher-level quality standards the CO includes in FAR clause 52.246-11(a) of the prime contract, in subcontracts “(1) for [the supply of] critical and complex items or, (2) when the technical requirements of a subcontract require— (i) control of such things as design, work operations, in-process control, testing and inspection; or (ii) attention to such factors as organization, planning, work instructions, documentation control and advanced methodology.”

Commercial-Item Acquisitions: Notwithstanding the fact that commercial items could be of a complex nature or have a critical use, FAR 52.246-11 does *not* apply to commercial items or commercially available off-the-shelf items as defined in FAR subpt. 2.101.

Purchasing System Reviews: As noted above, the final rule now mandates that a contractor’s quality management system incorporate higher-level quality standards. The review of a contractor’s quality management system has long been a part of the CPSR process found at FAR pt. 44.

During the comment period preceding final rule publication, several commenters noted that mandating quality management system oversight of higher-level quality standards as part of the CPSR process

is duplicative of cost and effort. Given that higher-level quality standards expressed in the final rule are industry standards, industry already has robust self-governance and certification practices in place to ensure compliance with these industry standards. The FAR Council disagreed.

While third-party audits routinely establish that a contractor has a documented process in place, the Government contract quality assurance audit or review, by contrast, ensures that the contractor is executing performance in accordance with its documented processes. Review of a contractor’s implementation of higher-level quality standards during a CPSR is consistent with the Government contract quality assurance function and responsibilities codified in FAR pt. 46. Moreover, although third-party audits are performed by audit organizations hired by the contractor, these audit organizations do not have the formal, legal authority to represent the Government, nor do they have the Government’s primary interests at stake. Therefore, including review of the contractor’s quality management system as part of a CPSR is consistent with the responsibilities of the Government contract quality assurance process.

The final rule does not change the methodology for CPSRs. The final rule adds content to be reviewed during the CPSR process. While an adequate purchasing system is only one part under the main sections of an adequate quality management system, the addition of higher-level quality standards does not dramatically expand the scope, nor change the methodology of a CPSR. As the final rule adds CPSR content when higher-level quality standards apply to the contract, the review process will confirm that the contractor is including appropriate flowdowns in its purchase orders. CPSR criteria established at the onset of the review of a particular contractor’s quality management system are bound by the framework of a contractor’s applicable quality standards, e.g., ISO 9001 Clause 7.4, Purchasing. With respect to the recent DFARS rule on counterfeit electronic parts for example, the final rule’s process for adding content to the CPSR of a DOD contractor’s counterfeit electronic part detection and avoidance system when higher-level quality standards are applicable aligns with the Government’s interest in what would otherwise be a major Government concern not covered by the FAR.

During CPSR where a contractor is subject to a higher-level quality standard covering the detection and avoidance of counterfeits, if a single quality

escape is documented that resulted in the delivery of a counterfeit part to the Government, the administrative CO is then required to examine the facts of the occurrence. The ACO is obligated to determine whether the escape was an isolated incident and could have been prevented if the contractor adhered to its internal detection and avoidance policies, procedures and controls before withholding CPSR approval. The ACO's examination under this scenario will not necessarily result in the contractor's quality management system being deemed inadequate or one containing major weakness (thereby necessitating withdrawal or withholding of CPSR approval). The inclusion of higher-level quality standards as review content will, on balance, begin to mitigate the risk associated with counterfeit and nonconforming items entering the supply chain.

Failure to Comply: The failure of contractors to implement and maintain an adequate quality management system that incorporates the necessary higher-level contract quality standards runs the risk that the contractor will fail CPSR. In addition, the contractor is susceptible to the Government's withholding of contract payments, contract termination, suspension, debarment or worse.

How the Final Rule Affects Contractors—As of December 26, contractors must be familiar with and implement certain higher-level quality requirements when they manufacture or supply items of a complex and critical nature. Many contractors, DOD CAS-covered contractors specifically, are already obligated to implement a robust counterfeit electronic parts detection and avoidance system. This final rule is one in the trifecta of recent final and proposed rules requiring contractors and subcontractors, regardless of CAS coverage, to implement internal policies and procedures that reduce the substantial risk of counterfeit and nonconforming goods entering the

supply chain. Many contractors are already ISO or AS certified, or are already familiar with the examples of higher-level quality standards now included in the final rule. Smaller contractors not specifically ISO or AS certified may already incorporate and adhere to the general requirements of ISO or AS standards. As the included examples of higher-level quality standards are existing industry standards, the adverse impact or burden to contractors may be minimal.

Conclusion—The final rule seeks to ensure that Government agencies take a risk-based approach in assessing the nonconforming items entering the supply chain under a particular contracting activity. Based on that risk assessment, the CO is authorized and directed to determine the necessary higher-level quality standards applicable to the solicitation and contract, and ensure the flowdown of these standards to the prime contractor and its subcontractors at any tier.

Existing agency procedures will provide guidance to the CO in determining which higher-level quality standards are necessary and which standards should apply to a given contracting activity. Contractors no longer enjoy the flexibility to adopt systems and practices that reflect the contractor's perception of an appropriate standard when supplying complex and critical items. This final rule, the DFARS clause on counterfeit electronic parts and the proposed FAR rule on the expanded reporting requirements on nonconforming items are designed to work in concert to mitigate the substantial risk that nonconforming and counterfeit items pose to the Government supply chain, the warfighter and national security.



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