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## *Supply Chain Assurance and Fiscal Austerity*

The defense business requires a certain amount of prudent tea-leaf reading – especially in these times of actual and projected fiscal austerity. This austere environment is coming as demands on U.S. defense commitments are nevertheless increasing significantly. Secretary of Defense Chuck Hagel directly addressed those challenges last week, saying that major choices are in the offing, including -- “change that involves not just tweaking or chipping away at existing structures and practices but, where necessary, fashioning entirely new ones that are better suited to 21<sup>st</sup>-century realities and challenges.” He went on to say that reshaping the defense enterprise means confronting “the principal drivers of growth in the [Defense] department’s base budget -- namely acquisitions, personnel costs and overhead.”

What all this means for the future of the Defense Industry is anyone’s guess, of course. What seems a near-certainty, however, is that significant program terminations are a possibility (if not a likelihood). Also, major new programs are unlikely. Nevertheless, demands on defense resources will be increasing. Therefore, the capabilities of existing forces and equipment will have to be maintained and possibly improved (as budgets permit). That will mean that equipment returning from overseas operations likely will have to be refurbished, certainly repaired, and in some instances upgraded. There will doubtlessly be significant contracts issued for these sorts of work.

It will be of particular importance that contractors performing those tasks under defense contracts have robust supply-chain assurance measures in place and fully functioning, given the increasing frequency of counterfeit parts one reasonably may expect to encounter when refurbishing older electronic systems (which are more likely to contain obsolete parts requiring replacement). In this regard, it is common that insurance brokerage and risk management firms supporting defense contractors provide coverage in the area of “supply-chain risk.” Contractors should note, however, that such coverage up to this point generally has not covered supply-chain risks of defense contractors associated with counterfeit parts. Those risks are substantial, and have drawn the attention of the Defense Department and Congress, as well as **allied countries**.

The Defense Authorization Act for FY2012 (Section 818) directed the DoD to establish policies and procedures to detect counterfeit electronic parts before incorporation into DoD systems. Congress mandated those regulations (DFARS) to be in place by 26 September, 2012. As of early April of this year, that regulatory effort was still ongoing (under review) at the administrative level (**DFARS CASE 2012-D055: DETECTION AND AVOIDANCE OF COUNTERFEIT ELECTRONIC PARTS**), with no definite end date in sight.

Whatever form the DFARS finally takes when issued, the DAA (FY 2012) itself provides for significant penalties for both individuals and companies intentionally and knowingly trafficking in counterfeit parts (e.g., \$2,000,000 for individuals, \$5,000,000 for companies, up to 10 years in prison for a first offense, and significant enhancements for repeat offenses, and where bodily injury or death is involved -- other than enemy death). These penalties are in addition to other steps available under existing law (such as suspension and debarment, Civil False Claims, etc.).

Defense contractors will have to take additional steps to ensure the integrity of their supply chain in light of the substantial “stick” involved in the DAA’s approach to the issue. Prudence will require regular, documented monitoring and incorporation of industry best practices as a major component of a robust, on-going compliance program -- and periodic, related adjustments to their own purchasing and flow-down provisions.

Moreover, the cost of remedial steps taken to mitigate instances of “counterfeit escape” is expressly unallowable -- except in certain, very limited circumstances (thanks to the DAA for FY 2013). This fact, reporting requirements, and short contractor-response times mandated by the DAA for remedial effort in the field, add further economic incentives for contractors to have a well-maintained, rigorously applied compliance regime. Accordingly, aggressive steps are plainly indicated for contractors -- especially considering that this potentially costly aspect of “supply-chain risk” is not currently (and unlikely to be) covered in standard policies in the near-term, or at least until better methods of analyzing (and quantifying) it are developed by the insurance industry.

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