



Government Contracts Advisory

December 7, 2010

Revised Proposed Rule May Significantly Impact Contractor Cash Flow Under Government Withholds for “Deficiencies” Identified in Contractor “Business Systems”

On December 3, 2010, the Department of Defense issued a proposed DFARS rule (the “revised proposed rule”) that, if enacted, may significantly impair contractors’ cash flow and lead to increased litigation and disputes. See 75 Fed. Reg. 75,550 (Dec. 3, 2010). The Department of Defense had previously issued a proposed rule on this topic on January 15, 2010 (the “initial proposed rule”). See 75 Fed. Reg. 2,457. We reported on the initial proposed rule on January 25, 2010. Available at <http://www.mckennalong.com/news-advisories-2234.html>. The Department of Defense received, after publication of the initial proposed rule, hundreds of comments from respondents, including industry. As a result, the Department of Defense has re-issued the proposed rule and has again requested comments. This proposed rule reinforces the procedures, first described in the initial proposed rule, under which administrative contracting officers (“ACOs”) can withhold portions of payments when contractors’ “business systems” contain “deficiencies,” as determined by ACOs, with the assistance of Defense Contract Audit Agency (“DCAA”) audits. This revised proposed rule targets deficiencies in the following contractor business systems: (1) accounting systems; (2) estimating systems; (3) purchasing systems; (4) earned value management systems (“EVMS”); (5) material management and accounting systems (“MMAS”) and; (6) property management systems.

While the revised rule reduces some of the penalties, industry still has good reason for concern. The proposed rule would still be implemented as a DFARS business systems clause, with a certification requirement which could easily be argued to be the basis for a false claim in the event of an alleged non-compliance. Further, the rule still permits contractor payments to be withheld over a broad spectrum of contract types if the ACO determines that there is a single, poorly defined, “deficiency” in a contractor “business system.”

Changes from the Initial Proposed Rule Include Reductions To the Amount of the Withholding

In response to the publication of the initial proposed rule, the government received over 350 comments, many of which voiced a staunch opposition to various provisions included in the initial proposed rule. As a result, the revised proposed rule contains the following noteworthy changes from the initial proposed rule:

- removed the language which set forth procedures for withholding up to 100 percent of contractor payments if the ACO determined that the business system deficiencies “are highly likely to lead to improper contract payments being made, or represent an unacceptable risk of loss to the government;”
- lowered the cumulative percentage of payments that can be withheld based on deficiencies in one or more business systems from 50 percent to a maximum of 20 percent (10 percent for small businesses) of payments owed to the contractor under an applicable contract;
- reduced the amount that can be withheld for each business system deficiency from 10 percent (per the initial proposed rule) to five percent (two percent for small businesses);

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- permitted the ACO to decrease the amount of the withholding from five percent to two percent (two percent to one percent for small businesses) if an approved contractor corrective action plan mitigates the government's risk by increasing the probability that the system deficiency will be corrected in a timely manner;
- established a threshold of \$50 million in expected contract value for the inclusion of the business systems clause in solicitations and contracts (note, business systems are company-wide or segment-wide systems with established policies and procedures that are applied across multiple contracts);
- permitted the ACO to discontinue the withholding of payments and release any payments previously withheld when the ACO determines that the contractor has corrected any deficiencies after receipt of auditor or "functional specialist" verification, and;
- provided for the ACO, in consultation with the auditor or "functional specialist," to discontinue the withholds prior to audit verification if the contractor submits evidence that the deficiencies have been corrected.

The Revised Proposed Rule Still Contains Ambiguous Terms

In response to criticism about the lack of definition, the revised proposed rule provides that a "deficiency" means "a failure to maintain one or more system criteria of an acceptable business system." The revised proposed rule then provides additional acceptability criteria for each of the six systems that make up a contractor's business system. For example, the proposed purchasing system administration clause includes 23 separate system criteria against which to measure a contractor's purchasing system. Many of these criteria, however, are subject to subjective application, and disagreements are almost certain.

The Department of Defense has also remained steadfast in its desire not to include a materiality provision for each "deficiency." Respondents commented that such a requirement would help the government to make a distinction between minor deficiencies that likely would pose no threat of significant harm to the government, and material deficiencies that would potentially pose such a threat. However, those suggestions seem to have fallen upon deaf ears; the revised proposed rule contains no materiality requirement.

The Proposed Withhold Process

Pursuant to the terms of the revised proposed rule, the ACO (usually based on a DCAA audit recommendation) would provide an initial determination, in writing, to the contractor that details any system deficiencies. The initial determination must be sufficiently detailed to allow the contractor to understand the deficiency and the alleged potential harm to the government.

The contractor must respond to the ACO within 30 days with a writing that states the contractor's grounds for disagreement with the deficiency finding (assuming the contractor disagrees). The ACO would then provide the contractor with a final written determination. If the ACO believes that any of the deficiencies "adversely affect the contractor's business system leading to a potential risk of harm to the government," the final determination will include a notice to withhold payments. The ACO would then, as applicable, withhold five percent (two percent for small businesses) of amounts due from progress payments and performance-based payments, and unilaterally issue a contract modification requiring the contractor to withhold five percent (two percent for small businesses) from its billings on interim cost vouchers on cost, labor-hour, and time-and-materials contracts that contain the Business Systems Clause until all deficiencies have been corrected.

If the contractor receives a final determination of system deficiencies, the contractor shall, within 45 days of receipt of the final determination, either correct the deficiencies or submit a corrective action plan demonstrating milestones and actions to eliminate the deficiencies.

If the contractor submits an acceptable corrective action plan, the ACO will, as appropriate, reduce the withholding to two percent (one percent for small businesses) from progress payments and performance-based payments and issue a unilateral contract modification to reduce the percentage withheld on interim cost-reimbursement vouchers to two percent (one percent for small businesses) until the ACO determines that all deficiencies have been corrected. However, if the ACO believes the contractor is not adhering to the corrective action plan, the withholding can be upwardly adjusted to the initial withholding amounts.

Recommendations

Due to the potentially significant impact of the revised proposed rule on contractor payments and cash flow, we recommend that contractors and industry associations submit comments to the revised proposed rule. Comments

are due on or before January 3, 2011, and contact information for comments can be found at 75 Fed. Reg. 75,550.

The revised proposed rule, if implemented without changes, will usher in an unprecedented and dangerous new era of government leverage over the financial aspects of contractors' business systems based upon vague and indecipherable standards which unquestionably favor the government and provide little, if any, protection to contractors--with the possible exception of the withholding caps. If enacted, this rule would confer upon the government the right to reduce otherwise appropriate contract payments based upon a single deficiency, upon its assertion that the "deficiency" presents a potential risk to the government. The standard proposed provides no protection to contractors while literally imposing on them a requirement for perfection--*i.e.*, the only way to assure avoidance of withholding of payments is to maintain a system with no deficiencies, thus creating no possibility of an argument over risk of harm to the government.

Moreover, the revised proposed rule, as a practical matter, further insulates DCAA from challenge by independent contracting officers, as the drafters made it clear in their comments that, even though the ACO must make the required findings, the December 4, 2009 Department of Defense memorandum entitled "Resolving Contract Audit Recommendations" will apply to disagreements between the ACO and DCAA. The December 4 memorandum provided for a resolution process to be utilized when the contracting officer significantly disagreed with DCAA's findings of a particular audit. Specifically, the December 4 memorandum defined a "significant disagreement" as instances where the contracting officer plans to sustain less than 75 percent of the total recommended questioned costs in a DCAA audit report on a contractor proposal value at \$10 million or more. The December 4 memorandum provided that if the contracting officer and DCAA auditor could not resolve their disagreement, the Department of Defense component's management could review the contracting officer's decision. In the event such efforts are unsuccessful, the December 4 memorandum notes that the issue should then be elevated to Mr. Shay Assad, Director, Defense Procurement and Acquisition Policy, to discuss the disagreement. That memorandum, however, does little to stem contractor apprehension that contracting officers will be able to adequately exercise their authority.

Contractors should review and understand their systems thoroughly. By doing so, they may be able to challenge DCAA during the field audit or, in the very least, ensure that DCAA has all the facts necessary to make findings of compliance. Our experience has been that, in this era, once DCAA circulates a draft report containing significant discrepancies, it stubbornly adheres to its conclusions.

Though the Department of Defense's position is that the withholding called for in the proposed rule is not subject to the Prompt Payment Act's interest provision, the fact that the systems in question are applicable to many, if not all, of a contractor's Department of Defense contracts, presents the specter that the total amounts withheld may be extremely large. If the government is unable to establish that the alleged deficiency is in fact not a deficiency, or does not prove the requisite potential risk of harm to the government, it would then be in breach of the contracts under which the withholding was implemented. In those circumstances, contractors would be entitled to file claims under the Contract Disputes Act, among other possible remedies. Such a scenario highlights what a potentially onerous and unwise proposition the proposed rule represents.

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