

ALERT

Interim DFARS Rule Authorizes Payment Withholdings Up to 10% for Contractor Business Systems With Significant Deficiencies

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On May 18, 2011, the Department of Defense (DoD) issued an Interim Rule (76 Fed. Reg. 28,856) for immediate implementation, defining contractor business systems and authorizing contracting officers (COs) to withhold a percentage of payments, under certain conditions, when a contractor's business system contains a "significant deficiency." The Interim Rule responds to industry comments on two earlier proposed rules (see 75 Fed. Reg. 2,457 (Jan. 15, 2010); 75 Fed. Reg. 75,5550 (Dec. 3, 2010)) and addresses section 893 of the 2011 National Defense Authorization Act (NDAA), which established statutory requirements for improvement of contractor business systems. Comments on the Interim Rule are due by July 18, 2011.

The Interim Rule includes a new DFARS contract clause, 252.242-7005, to be included in Solicitations issued on or after May 18, that defines contractor business systems to include accounting systems, estimating systems, purchasing systems, earned value management systems (EVMS), material management and accounting systems (MMAS), and property management systems. The Interim Rule authorizes a CO, after consultation with functional specialists and auditors and written notice to a contractor, to withhold up to 10% of contract payments for "significant deficiencies" in a contractor's business systems, or up to 5% for significant deficiencies in a single business system. According to the Preamble of the Interim Rule, these protections are required to "supplement existing enforcement mechanisms" and "mitigate the Government's risk while contractors correct business system deficiencies."

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The Interim Rule is intended to provide contractors an opportunity to address any significant deficiencies in advance of the CO imposing any payment withholding. Under the Interim Rule, if the auditor identifies any significant deficiencies, as defined by the Interim Rule, the audit report shall describe the deficiencies in sufficient detail to allow the CO to understand the deficiencies. If the CO determines that no significant deficiencies exist, he or she shall promptly notify the contractor that the system is acceptable and approved. If the CO finds one or more significant deficiencies due to the contractor's failure to meet one or more of the system criteria, then the CO is required to promptly make an initial written determination and notify the contractor, providing a description of each significant deficiency in sufficient detail to allow the contractor to understand the deficiency. The contractor then has 30 days to respond in writing to the CO's initial determination. Only after consideration of the contractor's response may the CO implement the payment withholding, if the CO finds that significant deficiencies remain (a "final determination"). Following a CO's final determination, the contractor shall have 45 days to either correct the deficiency or submit an acceptable corrective action plan showing milestones and actions to eliminate the deficiency. If a contractor submits an acceptable corrective action plan and the CO determines that the contractor is effectively implementing the plan, withholdings are to be reduced to 2% until the deficiency is eliminated. Once a significant deficiency has been corrected and no other material deficiencies remain, the CO will authorize the contractor to bill for any monies previously withheld.

Some of the key changes from earlier proposals implemented in the Interim Rule include:

- **Payment withholdings are only authorized for "significant deficiencies."** Reflecting guidance in section 893 of the 2011 NDAA, a "significant deficiency" is defined as a "shortcoming in the business system that affects materially the ability of officials of [DoD] to rely upon information produced by the system that is needed for management purposes."
- **The Interim Rule caps the total percentage of withholdings at 5% for significant deficiencies in a single system, and 10% for significant deficiencies in multiple systems.** In response to guidance in the 2011 NDAA, the cumulative payment withholding payment percentage was reduced from 20%. The CO may select one or more contracts containing the clause at 252.242-7005 from which payments will be withheld, up to the maximum total percentage.
- **The CO is required to reduce the withholding by at least 50% if the CO fails to make follow-up determinations within 90 days about the contractor's corrective actions.** Comments to the proposed rules raised concerns that DCAA and DCMA resources may not be available to perform timely follow-up audits or system reviews to confirm that a contractor has corrected a business system deficiency or has implemented a corrective action plan. While the Preamble asserts that "DCMA and DCAA have been working closely to align their resources and ensure work is complementary" to accommodate the new rule and "employ audit resources where they are needed," the Interim Rule appears to recognize that contractor responses to findings of significant deficiencies may outpace the CO's audit and review resources. Consequently, after a contractor notifies the CO in writing that a deficiency has been corrected, the CO must make a determination within 90 days as to the acceptability of the contractor's remedial action. If the CO fails to make a determination within 90 days, the amount of any future

withholding shall be reduced by 50% until the CO makes the required determination (although the Interim Rule is silent on the disposition of prior withholdings pending the CO's final determination).

- **Contractors are entitled to respond to the CO before a withholding is authorized.** Comments to the proposed rules raised concern over the lack of an appeals process before payment withholdings could be implemented. As noted above, the Interim Rule affords contractors a 30-day period in which to respond in writing to a CO's initial determination of deficiencies, and the Introduction to the Interim Rule stresses that "informal negotiation and alternate dispute resolution remain available, and, in fact, are encouraged as alternative methods of resolving disputes," but findings of significant deficiencies are nevertheless "at the sole discretion of the contracting officer." Findings of CAS-noncompliances that may underlie a separate finding of a "significant deficiency" may still be challenged as a standard contract dispute.
- **The Interim Rule did not adopt the suggestion to allow "inadequate in part" determinations.** DoD refused the suggestion to allow for "inadequate in part" determinations when minor system deficiencies do not affect an entire business system, and instead relied on the definition of "significant deficiency" to be the controlling factor in determining whether a payment withholding is required. Thus, if a system contains a deficiency, it will only be considered a "significant deficiency" if the CO determines that it materially affects the ability of DoD officials to rely upon the information produced by the system that is needed for management purposes.
- **The CO has greater flexibility in establishing the timeframe for completing a contractor's initial EVMS validation.** Whereas the initial proposed rules would have imposed a 16-month limit on this process, comments expressed concern that DCAA and DCMA audit resources are not currently capable of supporting that timeframe. The Interim Rule permits the CO to establish a reasonable timeframe.
- **Small business contracts are exempt from the Interim Rule and the \$50 million contract threshold has been removed.** The clause prescribing the new Contractor Business Systems clause at DFARS 252.242-7005 requires the resulting contract to be a "covered contract" and exempts small business contracts. All language pertaining to payment withholdings for small businesses was removed from the Interim Rule. As set forth in section 893 of the 2011 NDAA, "covered contracts" are those that are subject to the Cost Accounting Standards.

This Interim Rule poses a significant challenge to contractors who are found to have significant deficiencies in any business systems, and imposes a severe cash-flow penalty in order to protect the Government's interests. Given the extent to which business systems deficiencies can translate into substantial payment withholdings under the Interim Rule, contractors now have more incentive than ever to closely guard the integrity of their business systems, and to timely respond to issues raised during the audit and systems review processes. Contractors should vigilantly address any adverse findings, and take advantage of every opportunity to respond to adverse findings during the review process.

Furthermore, if a CO issues an initial determination of a significant deficiency, contractors should promptly engage the CO in negotiations, timely submit a written response, and actively pursue necessary remedial action. Once a contractor has addressed the deficiency, it should submit a written notice to the CO as soon as practicable, in order to start the 90-day clock that the CO has to make a determination on the adequacy of the corrective action. Given the resource challenges and attendant delays that face DCAA and DCMA auditors, it is more likely than not that the CO will require more than the allotted 90 days to review corrective actions, so contractors should maximize their ability to reduce any withholdings by 50% pending the CO's final determination.