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Authors:

Terry Elling
telling@Venable.com
202.344.8251

Jeffery M. Chiow
jchiow@Venable.com
202.344.4434

Proposed DFARS Rule: Withholding Payments to DoD Contractors

The Department of Defense (DoD) is accepting comments until March 16, 2010 on a proposed DFARS rule that, if implemented, will allow a Contracting Officer (CO) to withhold 10%, 50%, or even 100% of interim payments to contractors where the CO determines that a contractor's "business systems" are deficient. The proposed rule poses a significant business risk to DoD contractors of all sizes and continues a trend of increasing compliance burdens throughout the government contracting community. In light of the palpable impact to contractors' bottom line, now is an important time to reevaluate the costs of compliance and either establish or review current business systems for potential deficiencies so that any corrections may be made before being threatened with withholding of payments.

Background. In late 2008, the Federal Acquisition Regulation (FAR) imposed a rule requiring that contractors disclose certain violations of law under Title 18 of the U.S. Code, violations of the Civil False Claims Act and significant overpayments. At the same time, DoD audit guidance from the Defense Contract Audit Agency (DCAA) made a fundamental shift away from cooperation with government contractors. As detailed in Venable's June, 2009 government contracts update,¹ DCAA's audit guidance memoranda issued in 2008 and 2009 imposed rigorous new timelines for responding to audit requests for records and access to contractor personnel. The guidance also provided that in audits of contractors' internal control systems, an auditor could no longer find a contractor system inadequate "in part," but must find the entire system inadequate and take action to suspend payment of invoices where a single control objective was not met. New DCAA guidance also established a procedure to quickly escalate pressure on contractors who failed to immediately comply with record requests or who denied auditors access to personnel (despite the fact that auditors have no discernable legal basis to demand access to personnel).

Under increasing political pressure to reign in perceived contracting abuses, former DCAA Director April Stephenson's public comments described a "brave new world" in which auditors exercised less discretion and demonstrated more "skepticism." In her prepared statement and comments at a May 2009 hearing of the Commission on Wartime Contracting in Iraq and Afghanistan ("CWC"), Former Director Stephenson expressed frustration over cases where DCAA had found internal controls, *i.e.* business systems, inadequate but contractors continued to receive contract payments because it was determined that the contractor's services were too vital to the mission. She proposed a regulatory change that would mandate automatic partial withholding of contract funds whenever a contractor failed to meet any internal control system objective. The CWC held another hearing in August 2009 devoted solely to the question of ensuring that contractors maintain adequate business systems.

Proposed Withholding Rule. The proposed rule defines six separate business systems and states that a CO "will immediately withhold ten percent of each of the Contractor's payments under this contract" based on the CO's determination that any of those business systems is deficient. The business systems which could be found deficient, with the corresponding Office of Management and Budget (OMB) requirements, include:

- o Accounting Systems (OMB Clearance 9000-0011);
- o Earned Value Management Systems (OMB Clearance Pending),
- o Estimating Systems (OMB Clearance 0704-0232),
- o Material Management and Accounting Systems (OMB Clearance 0704-0250),
- o Property Management Systems (OMB Clearance Pending), and
- o Purchasing Systems (OMB Clearance 0704-0253).

Under the proposed rule, if a contractor submits an acceptable corrective action plan within 45 days of receipt of a notice of the CO's intent to withhold, but has not completed action to correct the identified deficiencies, the CO will reduce the amount withheld to five percent of each payment until the CO determines that the Contractor has corrected the deficiencies.

A CO may withhold payments for deficiencies in more than one business system, but the cumulative percentage of payments withheld is limited to fifty percent of contract payments. Nonetheless, if the CO determines that there are one or more system deficiencies that are "highly likely to lead to improper contract

payments being made, or represent an unacceptable risk of loss to the Government," then the CO "will withhold up to one hundred percent of payments" until the CO determines that the contractor has corrected the deficiencies.

Practice Points. The automatic withholding of 10% or more of contract payments whenever a business system is found inadequate can have a significant impact on a contractor's operations. As always, contractors should endeavor to cooperate with the CO and, if applicable, DCAA to satisfy their contractual, legal and regulatory obligations.

Consider performing an external audit or other assessment of internal controls related to the business systems that are the subject of the proposed rule. This should enable a contractor to address any potential weaknesses in advance of an audit and, hopefully, avoid having to address any inadequacies in business systems in the context of an adverse audit report.

There are many benefits to maintaining well-functioning business systems. These systems provide visibility over critical contract metrics and allow businesses to manage workload and costs. At the same time, companies must consider the increased risk and costs posed by the new withholding requirement and make informed decisions about the business tools they invest in and the types of contracts for which they choose to compete.

¹ Available at [Government Update](#).

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