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Expert Analysis

Let's just eliminate all pretense of balance

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Under our system of laws, legal liability has customarily been based on certain showings, *e.g.*, that an act or omission actually caused an injury. And when injury and proximate cause have been established by a preponderance of the evidence, the liability has usually been measured in terms of the aggrieved party's actual loss, with penalties and punitive damages reserved for egregious situations involving malicious or willful misconduct or gross negligence. These are useful legal constructs and they have served us well over the years in helping to avoid misuse of the law through the imposition of liabilities without proof of injury or without regard to the damage actually caused by the alleged misconduct.

Proximate cause, injury in fact and proportionality of response were nice concepts while they lasted, but they appear to have outworn their welcome within the Department of Defense. Under regulations proposed by DOD, it would soon have the power to withhold anywhere from 10 percent to 100 percent of the payments otherwise due and owing to its contractors. The basis for this withholding would be a mere determination by the Defense Contract Audit Agency that one or more "deficiencies" exist in any of the following contractor systems: cost estimating, earned value management, or EVMS; material management and accounting, or MMAS; accounting; purchasing; and property management.

A "deficiency" identified in one of those systems triggers a 10 percent withholding; a deficiency in any other of the systems triggers an additional 10 percent withholding, up to a total withholding of 50 percent.

And, if there is determination 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 ACO [administrative contracting officer] will withhold up to 100 percent of payments." DFARS 252.242-7XXX(d)(4). See 75 Fed. Reg. 2462 (Jan. 15, 2010).

This last point warrants repetition — a 100% withholding of payments on the basis of a single business system deficiency without any requirement for proof of an actual improper payment or any proof that any such improper payment bears any quantitative relationship to the underlying system deficiency. And guess what? The government is likely to take the position that, under the standard disputes clause, the contractor is obligated to continue working while disputing the alleged deficiency.

Proximate cause, injury in fact and proportionality of response appear to have outworn their welcome within the Department of Defense.

In reality, DOD does not expect contractors to work for nothing. Rather, it expects them to forgo the disputes process and conform their business systems to its will because to do otherwise creates too much of a cash flow risk for an indeterminate period of time. In effect, the rule is designed to allow for the unilateral rewriting of contractor business systems through the coercive effect of arbitrary and punitive withholdings that render the prospect of meaningful relief under the disputes clause an illusion. This rule is unfair on its face.

THE SUBSTANCE OF THE PROPOSED RULE

The proposed rule was issued for comment Jan. 15, and is quite straightforward in its terms. Under the regulation, a new clause titled "Business Systems" would be incorporated in Part 252 of the DOD Supplement to the Federal Acquisition Regulation.

First, the clause would require the contractor to "establish and maintain acceptable business systems in accordance with the terms and conditions of this contract," and it defines "business systems" to mean:

- The EVMS (if the contract includes the clause at DFARS 252.234-7002).
- The estimating system (if the contract includes the clause at DFARS 252.215-7002).
- The MMAS (if the contract includes the clause at DFARS 252.242-7004).
- The property management system (if the contract includes the clause at FAR 52.425-1).
- The purchasing system (if the contract includes the clause at FAR 52.244-2).
- The accounting system (if the contract includes a new proposed clause that would be found at DFARS 252.242-7YYY).

Second, if any of the systems is determined to suffer from a deficiency, the ACO will immediately withhold 10 percent of each of the contractor's payments under this contract. While this ostensibly is a contract-specific withholding, any deficiency identified in a contractor system will obviously, and by definition, affect all contracts to which the system applies.

Third, the 10 percent withholding is independently applicable to each of the delineated business systems. Thus, a deficiency in the estimating system and a deficiency in the property management system would each subject the contractor to a 10 percent withholding, thus resulting in a 20 percent reduction in payments.

Fourth, if the ACO determines that one or more system deficiencies either are highly likely to lead to improper contract payments being made or represent an unacceptable risk of loss to the government, the ACO will withhold up to 100 percent of payments until the ACO determines that the contractor has corrected the deficiencies.

Fifth, the withholding applies to a broad array of payments, including all interim payments under cost-reimbursement, incentive-type, time-and-materials and labor hours contracts, and to progress and performance-based payments.

THE PROCESS FOR IMPLEMENTING THE WITHHOLDING

The process pursuant to which contractors would find themselves working for reduced pay (or even no pay) is also laid out in the proposed rule in a by-the-numbers routine:

- The auditor documents the deficiencies in a report that is supposed to be sufficiently detailed to educate the ACO with respect to the necessary corrective action and the magnitude of the risk posed by the deficiency.
- The ACO determines if there is a deficiency.
- The ACO notifies the contractor.
- The contractor has 30 days to respond to the notice.
- If the ACO determines that there is a deficiency, payments are immediately withheld at the levels described above, depending on the number of systems affected or the highly likely risk of improper contract payments.
- If an acceptable corrective action plan (complete with “milestones”) is submitted within the following 45 days but it has not been completely implemented within that 45-day window, the withholding will be reduced to 5 percent per system.
- Once all deficiencies have been corrected, withholdings will be discontinued and prior withholdings will be released.

WHY THIS PROPOSED RULE IS UNFAIR

Apologists for this proposed rule reflexively point to the accounting abuses of government contractors and declaim the need for decisive action and effective weapons in the war against fraud, waste and abuse. Politically, these words provide a powerful cover story for the proposed rule. But once one parses the rule with any semblance of balance, it becomes apparent that the cover story is designed to mask an egregious case of overreaching by the United States, one that is fraught with the potential for abusive conduct by government actors against whom there are no effective constraints.

Reason No. 1

The rule kicks in with a report of system deficiencies. The rule would require that report to describe what needs to be done to correct the deficiency and the magnitude of the purported risk. It does not, however, require an explanation of what the deficiency is, why it is a deficiency at all, what regulatory standards were invoked in making the determination, or whether the deficiency is, in the context of the contractor’s overall business, at all material. The required report, as defined by the rule, thus would be decidedly one-sided and slanted.

Reason No. 2

This report originates with the auditor. Given the incredibly dire financial consequences that can ensue from a report that is erroneous or based on a misinterpretation of applicable law or generally accepted accounting principles, it perhaps useful at this juncture to consider the fact that the Defense Contract Audit Agency has had more than a few quality-control problems in recent years. As recently as last year, the Government Accountability Office issued a report that offered the following observations about DCAA:

DOD expects contractors to forgo the disputes process and conform their business systems to its will.

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[W]e have concluded that DCAA's quality-control system for the period covered by the last DOD IG [inspector general] peer review was not effectively designed and implemented to provide assurance that DCAA and its personnel comply with professional standards.

DCAA's human capital management practices of hiring auditors at the entry level and assigning them to complex audits with little classroom training or on-the-job experience and minimal supervision have contributed to the audit problems we identified.

The most pervasive audit deficiency we identified was insufficient testing to support DCAA's reported conclusions and opinions.

DCAA's audit-quality-assurance program was not properly implemented, resulting in an ineffective quality-control process that accepted audits with significant deficiencies and noncompliance with ... [generally accepted government auditing standards] and DCAA policy.

The failure to perform quality audits leaves government contracting officers and disbursing officers with inadequate information.

DCAA has not yet addressed the fundamental weaknesses in its mission, strategic plan, audit approach and human capital practices.

See Gov't Accountability Office, *Widespread Problems With Audit Quality Require Significant Reform*, GAO-09-468 (September 2009).

Lest anyone think that these systemic deficiencies in DCAA's discharge of its audit functions have no impact on the quality of its business systems audits, the GAO further said in testimony to a Senate committee:

DCAA's policy to eliminate the "inadequate-in-part" opinion for contractor internal control systems audits does not recognize different levels of severity of control deficiencies and weaknesses and could unfairly penalize contractors whose systems have less severe deficiencies by giving them the same opinion — "inadequate" — as contractors having material weaknesses or significant deficiencies that in combination would constitute a material weakness. DCAA would benefit from outside expertise to develop effective audit policy guidance and training on auditing standards.

See DCAA Audits, *Widespread Problems With Audit Quality Require Significant Reform*, Hearing Before the S. Comm. on Homeland Sec. & Governmental Affairs, GAO-09-1009T at 15 (Sept. 23, 2009) (statement of Gregory D. Kutz, Managing Director, Forensics Audits & Special Investigations, Gov't Accountability Office, & Gayle L. Fischer, Assistant Director, Fin. Mgmt. & Assurance, Gov't Accountability Office).

Reason No. 3

It is true that the proposed rule does not empower DCAA to withhold payments. That decision is vested in the administrative contracting officer. There are at least two problems here. First, there are no objective standards against which the ACO's evaluation is required to be conducted.

Second, in an era in which contracting officers' independence has been significantly subverted by a marked propensity by auditors to refer ACOs to the inspector general for investigation when they disagree with the auditor's recommendations, that inde-

pendence is not much of a bulwark against an overly zealous auditor's inexperience, negligence or mistake.

This concern is not the product of contractor paranoia, as a March 13, 2009, memorandum from the assistant director of DCAA for policy and plans (PAS 730.4.A.4) expressly encourages referrals when an auditor believes that a contracting officer's decision affords a contractor unreasonable or excessive costs and/or profit. That is a condition that, by definition, exists every time a contracting officer rejects auditor recommendations. Given this political climate, a rejection of DCAA's recommendations these days will require an ACO with more than an average allotment of spine.

Reason No. 4

There is no requirement that the deficiency — however determined and against what standards — have any potential for a material impact on amounts paid or to be paid by the government. To the contrary, the proposed rule is very clear: Once a deficiency is identified by the ACO and has gone uncorrected for a period of 30 days, "the ACO will immediately withhold 10 percent" — or 20, or 30, or 40 or 50 — depending on the number of systems in which deficiencies have been identified.

This withholding is over and above, for example, the built-in 20 percent withholding under the standard progress payments clause. And remember, there is no relationship whatever between the amount of the withhold and any injury in fact to the government. In fact, there need not be *any* injury in fact.

Reason No. 5

The bases for the withholding of 100 percent of contract payments are absurd. The first is that there are one or more system deficiencies that are highly likely to lead to improper contract payments. Again, injury in fact is not required; the 100 percent withholding is a bit like a unilaterally imposed preliminary injunction barring all payments to the contractor for services rendered and to be rendered because something untoward may happen in the future. That "something" for which the government is authorized to grant itself this ersatz injunction is the highly likely possibility of improper contract payments. The magnitude of the impropriety is irrelevant under the proposed rule as written. A system deficiency that could have a monetary impact of \$100 can be used to justify the complete withholding of millions of dollars for work already performed and to be performed.

The second basis for a 100 percent withholding is equally "loose": an unacceptable risk of loss to the government. Questions abound. What standards will be applied? Is all risk of loss to the government per se unacceptable? How immediate must the risk be, and with what level of materiality (if any) to justify a total suspension of payments?

Reason No. 6

The proposed rule is unnecessary. DFARS 242.7502 already authorizes the ACO to suspend a percentage of progress payments or a reimbursement of costs but, unlike the proposed rule, it requires the suspension to be proportionate to the estimated cost risk to the government. Similarly, the MMAS clause at DFARS 252. 242-7004 allows a reduction in progress payments or the withholding of costs, but only when the deficiencies "have a material impact on government contract costs" and, even then, only by an "appropriate percentage based on affected costs." *Id.* ¶ (d)(3).

The bases for the withholding of 100 percent of contract payments are absurd.

Reason No. 7

It is curious that the proposed rule spells out with punctilious exactitude the time period when the hammer falls on the contractor: immediately. But when the contractor has actually bent to the will of DCAA and made the necessary (or unnecessary) corrections to its systems, there is no timetable for the repayment of the prior withholding. And the payment withholdings are not subject to the interest penalty provisions of the Prompt Payment Act. So, the government, which does not need to have been injured at all by the improper payment of funds in order to withhold payments, gets to hold the money for an indeterminate period, without incurring interest.

Reason No. 8

Try explaining the predictability of this rule to a financing institution when discussing the possible assignment of accounts receivables or to an acquiring entity that is unfamiliar with government contracting.

Reason No. 9

FAR 52.233-1 provides:

- (i) The contractor shall proceed diligently with performance of this contract, pending final resolution of any request for relief, claim, appeal, or action arising under the contract, and comply with any decision of the contracting officer.

The United States will likely contend that this duty to proceed survives a unilateral government decision to stop paying the contractor. There are ample bases on which to contest any such suggestion. But if the government position were to be upheld, one would certainly have to question the supposed universality of the 13th Amendment.

CONCLUSION

The government has enough weapons with which to bludgeon contractors. The ability to stop payment in amounts that bear no relationship to the injury in fact suffered by the government as a result of an alleged business system deficiency is not only unnecessary, it's just plain wrong.



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