We've been known to tell audiences that preparing a CAS cost impact proposal and defending it through audit is the most difficult task to perform in the complex (and perhaps arcane) world of government contract cost accounting. It has recently come to our attention that we were wrong. Indeed, there is one calculation even more difficult to prepare and defend through audit, even less well-understood, and even more complex (and arcane) than a cost impact analysis—the segment closing pension adjustment calculation mandated by Cost Accounting Standard 413.

When the second incarnation of the CAS Board revised Standards 412 and 413 in March, 1995 they took already ambiguous, complex and poorly understood Standards and made them even more onerous. In the words of former OFPP Administrator Angela Styles, the revisions "sparked an explosion of litigation" as the Government, contractors, and the Courts struggled to come to some understanding as to what the rules meant and how they could be executed in a practical sense by the contracting parties. One case, the matter of the General Electric Company's pension adjustments related to sales of several of its businesses, celebrates this week its *fourteenth* year of litigation—rivaling the infamous A-12 termination case for length.

The words of Cost Accounting Standard 413, at 48 C.F.R § 9904.413-50(c)(12), are relatively straight-forward, as is most of the CAS language. The Standard states (in part):

If a segment is closed, if there is a pension plan termination, or if there is a curtailment of benefits, the contractor shall determine the difference between the actuarial accrued liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated. The difference between the market value of the assets and the actuarial accrued liability for the segment represents an adjustment of previously determined pension costs.

It is the interpretation of the foregoing words that has baffled for years the best minds in the business, as different parties litigate different aspects of the requirements. Most of what we know (or think) we know of how to comply with this requirement comes from Judge Nancy Firestone of the U.S. Court of Federal Claims, a special (non-Article III) court established by the Tucker Acts to hear contract-related suits against the U.S. Government. Judge Firestone has waded through motions and briefs, and counter-motions and sur reply briefs, and expert report after expert report, trying to establish what the CAS Board intended the parties to do when a Government contractor (a) had a defined benefit pension plan, and (b) sold one or more of its CAS "segments" (or business units) to another business. Generally speaking, we applaud Judge Firestone's acuity, wisdom, and perseverance; and the Court of Appeals has also looked favorably on her decisions, often accepting her decisions as written and denying appeals by one (or both) parties. Other cases have been tried in the Armed Services Board of Contract Appeals (ASBCA), where several judges have tackled the messy problems associated with this Standard, with a somewhat greater variation in success. The latest guidance from the Courts concerns decisions made by this latter judicial body.

On September 14, 2009 the U.S. Court of Appeals, Federal Circuit, issued one of its relatively rare CAS 413 reversals of a lower court decision, one that is worth mentioning for several reasons. First, it should be noted that Apogee Consulting, Inc. is not a law firm and nobody here has any formal legal training. So what follows is simply a layperson's attempt to discuss several points found in the Appellate Court's decision. Second, it should also be noted that one (or both of the parties) may decide to appeal this decision further, perhaps requesting *certiorari* from the U.S. Supreme Court. (That's not likely, nor is SCOTUS likely to accept the appeal if made. Nonetheless, the Appellate decision should not be treated as final until all rights of appeal have been waived or exhausted.) Finally, let's be clear that this article is the personal opinion of the author, Nick Sanders, and in no way represents the opinion of The Raytheon Corporation (a party to the litigation) or any Apogee Consulting, Inc. client. That being said, let's look at a few aspects of the Appellate decision.

1. The segment-closing pension adjustment is a current period adjustment. In order to comply with the requirements of CAS 413-50(c)(12), the contractor must evaluate its pension plan assets and actuarial liabilities, and determine whether the plan is over- or under-funded. It must determine the U.S. Government's participation in any over- or under-funding (using a representative sample of prior years' contract activity), and apply that participation ratio to the amount of the calculated pension "surplus" or "deficit" (after making certain adjustments such as

excluding employee contributions). The amount so determined is a current period adjustment—either a credit or debit—that then flows to Government contracts in the indirect cost rates of the current period. What is striking about the Court's decision is that a failure to make the required calculation and determine the resulting credit or debit, and to reflect that entry in the current period's indirect cost rates—is a noncompliance with the requirements of the Standard. Moreover, the Court declared that simply making "an accounting allocation to the current period" is insufficient; what is required is an actual contract price adjustment—a "payment in the current period".

Those who have dealt with this series of actuarial analyses, contract participation reviews, and various calculations understand what the Court apparently did not. Calculating the requirement pension adjustment does not happen in a few hours or even days. It takes *months* to analyze the data and determine the status of the pension plan using the rules of CAS 413. It takes *months* to determine what years contributed to the pension plan over- or under-funding. It takes *months* to determine a representative sample of years, to determine the Government's participation in pension plan expenses for those years, and to then calculate the Government's overall percentage of current period pension surplus or deficit. If a contractor were to sell a business in the fourth quarter of its Fiscal Year, it would be near impossible to complete the required analyses and calculations by year-end. Even when one considers the six-month period after the books close (provided by the Allowable Cost and Payment clause, FAR 52.216-7) to be used for preparation of the year's final indirect cost rate proposal, one is hard-pressed to believe nine months is sufficient time. Indeed, given how few contractors survive DCAA audit of its segment-closing pension adjustment by DCAA without a CAS 413 noncompliance (leading in almost every instance to a protracted legal dispute), even a full year might not be enough time to calculate the adjustment in a manner deemed by DCAA to be in full compliance with the Standard as written and as interpreted by the Courts. Yet, the Appellate Decision is clear: contractors who do not complete their efforts in time to adjust the final indirect cost rates—and contract billings—for the fiscal year in which the sale took place are in noncompliance with CAS 413. Accordingly, the Government is entitled to recover overpayments and interest on those overpayments in accordance with the CAS clauses and underlying statute.

1. The noncompliance is created when the fiscal year ends without the required adjustment being made, but compound interest starts accruing on the day the segment is sold. There was

a school of thought that believed a contractor could not be in noncompliance with CAS until a contracting officer (variously called an "ACO" or "CFAO" in the regulations) issued a final decision officially determining that the contractor was in noncompliance. Generally, this would follow a DCAA audit report alleging noncompliance or recommending that the contractor be found to be in noncompliance, to which the contractor would have a chance to rebut or convince the contracting officer why DCAA was wrong in its audit finding(s). Given that interest on a contractor claim made under the Contract Disputes Act (CDA) does not start running until a contracting officer has issued (or is deemed to have issued) a final decision (and the contractor formally appeals that decision to the ASBCA or Court of Federal Claims), there was some sense of logic and inherent fairness that the Government should not be entitled to receive interest until the contracting officer had heard the stories of both DCAA and the contractor, and rendered a final decision. Another possible date could have been the contractor's fiscal year-end, or six months after year-end (when the contractor was required to submit it final indirect cost rate proposal, unless given an extension by the contracting officer). The Court found none of these dates meaningful, choosing instead to declare that the CAS 413 noncompliance took place when the contractor failed to make the required segment closing adjustment in the current period, and its segment closing date started the interest clock ticking. The rationale for this position was that the contractor has active contracts in the period in which its segment is closed; therefore failure to adjust one or more of those active contracts *in the current period* creates the noncompliance and results in Government overpayments. Remembering that pension plan cases involve millions (or sometimes hundreds of millions) of dollars, and that at least one of these cases has run for fourteen years without complete resolution, one quickly sees that this decision has a huge impact on the amount of money at stake.

Disposing of a business unit by sale or other means is a difficult endeavor. Contractors often spend considerable sums hiring outside advisors, consultants, and/or subject matter experts to conduct due diligence reviews or to help shape the final deal. We have previously discussed the importance of a rigorous due diligence review when acquisition or divestiture of a government contractor is being considered. To this discussion we now add the following warning, based on this recent Federal Circuit decision:

When considering acquisition or divestiture of a CAS-covered government contracting business unit (or segment) where a defined-benefit pension plan is involved, you must take into

consideration the CAS 413 implications. This means that, in addition to parceling out the pension plan assets and liabilities between buyer and seller, the parties must agree to cooperate in developing the segment closing adjustment. Further, the buyer and seller must plan on considerable devoting time and resources—and funds—to completing the adjustment and processing any credits/debits before the end of the fiscal years of one (or both) of the parties. Obviously, the deal structure (e.g., which party retains responsibility for pension plan assets and liabilities, and which party retains ownership of physically completed contracts) will determine who has the most to gain (or lose) from any noncompliance with the requirements of CAS 413. All of which will lead to more expensive deals, and thus to fewer deals. While it is true that there are not many contractors who still maintain active defined benefit pension plans, there are still enough to warrant this cautionary note. Moreover, it is not necessarily the active plans that will lead to the most troublesome calculations, but the plans for inactive and active legacy employees which, although closed to new participants, still must be addressed when the affected government contactor businesses are bought and sold.