When Westinghouse (subsequently known as Viacom, and now known as CBS) closed down its Machinery Technology Division (MTD) segment and nearly simultaneously sold its Electronic Systems Group (ESG) segment to Northrop Grumman in 1996, little did it know it was setting in motion a chain of events that would culminate, nearly fourteen years later, in a series of rulings from the U.S. Court of Federal Claims (CoFC) that would help CAS practitioners understand the complex operations of the segment closing adjustment required by CAS 413-50(c)(13).

We have written about this matter before—see links **here** and **here** . Suffice to say that CAS 413 is hard to fathom, difficult to comply with, and almost always leads to protracted litigation. Fortunately, Judge Firestone of the CoFC does a good job in unraveling the knots and explaining how to comply, and her decisions are generally upheld on appeal. This article will discuss two very recent decisions by Judge Firestone as they pertain to the disposition of the two CBS segments—ESG and MTD.

The ESG Sale

The ESG sale to Northrop Grumman was a complex transaction. Westinghouse transferred both pension plan assets and liabilities to Northrop Grumman—but not all of them. It retained certain pension assets and liabilities. That same year, Westinghouse submitted a segment closing adjustment claim to the Government. Meanwhile, Northrop Grumman merged the pension plan assets and liabilities it had received from Westinghouse into its own pension plan.

Westinghouse/Viacom/CBS's analysis showed a pension deficit—i.e., pension plan liabilities outweighed assets. Accordingly, it asked the Government to fund the deficit. A battle ensued and the matter has been the subject of at least two other CoFC cases. See this ESG decision **here** .

As part of the ongoing battle, CBS recalculated its numbers and its new analysis "includes the portion of the pension plan deficit that CBS transferred to Northrop Grumman." In other words, CBS was asking the Government to fund the entire pension plan funding shortfall that existed prior to the sale of the ESG segment.

Judge Firestone decided that there were clearly two separate processes in action. The first process was the segment closing calculation mandated by CAS 413, and the second process was the determination of how much of the calculated surplus/deficit would be attributed to the parties. She also addressed the requirements of the original CAS 413 language versus the requirements of the revised CAS 413 language. (CAS 413 was revised in 1995.)

Her decision is consistent with other CAS 413 cases she's decided: the segment-close calculation is controlled by the CAS language, while the amount of pension surplus/deficit each party bears is based on contract language. With respect to the first issue, Judge Firestone adjudged that—

> … a segment closing calculation under original CAS 413 must be made on all of the segment's pension assets and liabilities, including the portion of the segment's pension assets and liabilities that the segment seller transfers to the segment buyer. The court noted that unlike revised CAS 413, which limits the calculation to the portion of the pension assets and liabilities retained by the segment seller, original CAS 413 did not distinguish between the portion of the pension assets and liabilities retained by the segment seller and the portion of the pension assets and liabilities transferred to a segment buyer. … [T]herefore, segment closing calculations under original CAS 413 must be performed on the pension assets and liabilities of the entire segment without regard to the fact that some of these pension assets and liabilities were transferred to the segment buyer. (Internal citations omitted.)

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> The court therefore holds that the segment closing calculation for the sale of the ESG segment to Northrop Grumman with respect to contracts covered by original CAS 413 must include all of the segment's pension assets and liabilities attributable to those contracts, without adjustment for the pension assets and liabilities transferred to Northrop Grumman.

With respect to the second issue (how much of the calculated surplus/deficit should be attributed to each party), Judge Firestone noted that the Allowable Cost and Payment Clause (52.216-7) of CBS' flexibly priced contracts required that costs must be allowable pursuant to the requirements of FAR Part 31 which included, *inter alia*, that the costs must comply with CAS, or else Generally Accepted Accounting Principles (GAAP) if CAS did not apply.

Looking at the language of CAS 412, Judge Firestone noted that "a contractor may only claim payment from the government for pension costs if the contractor has a 'valid liability'." Judge Firestone looked at Statement of Financial Accounting Concepts (SFAC) No. 6 to define the term "liability," and determined that –

SFAC No. 6 defines 'liability' to mean the 'legal, equitable, or constructive duty or responsibility' to pay an obligation. Under SFAC No. 6, liabilities are defined as 'probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.' Later in SFAC No. 6, paragraph 42 explains that if liabilities are transferred or eliminated, those liabilities can no longer be claimed by the transferring entity. In this paragraph, which falls under the heading, 'Transactions and Events that Change Liabilities,' GAAP recognizes that a liability may be eliminated if it is transferred to another. Specifically, it provides that '[o]nce incurred, a liability continues as a liability of the entity until the entity settles it, or another event or circumstance discharges it or rem oves the entity's responsibility to settle it .'

(Emphasis added by Judge Firestone, internal citations omitted.)

Judge Firestone concluded—

Because CBS does not have any 'liability' for the pension obligations it transferred to Northrop Grumman, paying CBS for the transferred pension deficit would violate the CAS and GAAP. Thus, payment is not authorized under FAR 31.201-2 and is not permissible under the Allowable Cost and Payment Clause. Therefore, CBS's claim for pension costs attributable to the pension liabilities it transferred to Northrop Grumman must be denied.

Accordingly, Judge Firestone determined that, while the CAS 413 segment closing calculation must be performed on the entirety of the segment's pension plan assets and liabilities as they existed before the transfer, the Government was liable to CBS only for the amount of the pension deficit attributable to the assets and liabilities that CBS retained after the transfer to Northrop Grumman.

The MTD Closure

But Judge Firestone wasn't done yet. In a second CBS case decided the same day, she addressed the date on which the segment was actually closed—and therefore subject to the segment-closing pension adjustment of CAS 413. See the **MTD decision** here.

Those gentlefolk following these series of admittedly arcane cases will realize how important that date is. As we have previously noted, Court of Appeals (Federal Circuit) has held that the segment-closing pension adjustment is a *current period adjustment*—meanin g that a contractor is in noncompliance with CAS 413 if it fails to make the required adjustment prior to the end of the current fiscal year in which the segment closing takes place. Moreover, the Federal Circuit has also held that when a when a noncompliance with the requirements of 48 C.F.R. § 9904.413-50(c)(12) is alleged, then the government is entitled to interest compounded daily beginning on the *date that the segment was closed*. So determining the exact date of segment closure is critical.

One might think that determining the segment-closing date would be relatively straightforward—and normally it is. But Westinghouse/Viacom/CBS and its government customer created a set of circumstances that tested Judge Firestone's wisdom.

According to the Courts recital of undisputed facts, Westinghouse established the MTD segment in 1983 to provide technical and engineering support to the U.S. Navy's Naval Sea Systems Command (NAVSEA). The segment's 190 employees performed on two contracts (one was a follow-on contract to the initial award). In November 1995, NAVSEA informed Westinghouse that it would not be awarded a third follow-on contract and, within a month, Westinghouse told NAVSEA that it would therefore close the MTD segment effective February 1, 1996. In particular, Westinghouse notified NAVSEA (pursuant to its contract's Limitation of Funds clause) that remaining funds would be insufficient to cover the segment's closing costs, and that funding the segment's

pension deficit “could be significant.”

In executing its decision to shut down the MTD segment, Westinghouse gave its employees a 60-day notice of termination, sent its subcontractors notifications of terminations for convenience, and requested that its employees' secret facility clearance be terminated as of February 1, 1996. It notified NAVSEA that it would discontinue work on the contract (even though there was work remaining to be done) because of the funding constraints. NAVSEA was not pleased.

Sometime in January 1996, NAVSEA determined that it could fund the MTD segment-closing costs from “funds unrelated to the appropriated funds under the … contract and that [contract] funds … had not been fully expended.” The NAVSEA contracting officer “asked Westinghouse to continue work on the [contract] for national defense reasons.” As a result, MTD “agreed to reinstate its subcontracts and transfer” the remaining contract work to another segment (the Science and Technology Center, or STC segment). However, the MTD segment would continue to generate the contract billings, even though all work was performed by STC employees and other subcontractors. As Judge Firestone related, “By May 1, 1996, there were only two MTD employees remaining. These employees were not performing work under the contract, but were involved solely in the winding-down of the segment and in performing the billing functions requested by the government.”

Moreover, “The Defense Contract Audit Agency (‘DCAA’) audited MTD’s plant closings after the MTD facility closed. When the DCAA presented questions to MTD in April 1996, MTD advised the DCAA that it could not respond because MTD no longer had any employees.”

Nonetheless, when it came time to determine the segment-closing pension adjustment to be made pursuant to the requirements of CAS 413, the government argued that (under the language of the original CAS 413) a segment does not close until its contractual relationship(s) with the government are finally terminated and it would no longer be possible to adjust pension costs charged to the contract. The government contended that "even though MTD was no longer incurring pension costs through direct labor, MTD's pension costs 'could have been' adjusted through 1996 and 1997 if MTD had changed its CAS disclosure statement and allocated pension costs on some other basis." Using that logic, the government argued that the MTD segment closed on July 1, 1997—which was when work under the final contract was finally completed. CBS argued that the segment closing took place when the MTD segment stopped performing CAS-covered contracts that would allow for the amortization of pension costs. Accordingly, CBS argued that the MTD segment closed on February 1, 1996—which is when it stopped incurred direct and indirect costs.

Judge Firestone cleanly cut through the parties' arguments, quickly getting to the heart of the matter. She wrote, "…this court has held, and the Federal Circuit has affirmed, that the critical test for determining whether a segment closing has occurred is whether there are future cost accounting periods in which to adjust previously determined pension costs."

She continued—

It is also not disputed that while MTD subcontracted performance under the contract to STC, MTD remained the prime contractor on Contract No. 4030 after NAVSEA prevailed upon MTD to assume that role for funding and national security reasons. The record demonstrates that if NAVSEA had not prevailed upon MTD to retain its prime contractor

status, the timing of the segment closing in this case would not be in dispute. Once MTD had ceased work ... following termination of its security clearance and after it transferred the contract work to STC, it would have been 'closed.'

Judge Firestone concluded—

While it is no doubt true that MTD remained the prime contractor … after February 1, 1996 for billing purposes only in order to help the government, it is also true that under CAS 413, MTD was not able to charge pension costs to the government based on direct labor rates … after it had ceased operations on February 1, 1996. Accordingly, the MTD segment closed as of that date.

We continue to be both amazed and amused at the "firestorm of litigation" (to quote former OFPP Administrator Angela Styles) sparked by the Cost Accounting Standards dealing with defined-benefit pension plans. The litigation is understandable: the amounts of money at stake in each case almost prevent any type of negotiated settlement. But when it takes fourteen years (or more) for each of these cases to be decided, we have to wonder if this is the situation envisioned by the CAS Board(s)? Is there no simpler way to have government customers pay their fair share of pension costs, and no more than their fair share?

The good news is that most companies are moving away from defined-benefit pension

plans, so the litigation window has a finite life. But is the price we taxpayers are paying in the meantime—in terms of litigation expense, use of judicial resources, and corporate and government funds—worth it? We wonder ….