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## Decisions

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### Fed. Cir. Addresses Segment Closing Adjustment

*The DIRECTV Group, Inc. v. U.S.*, 2012 WL 233978 (Fed. Cir. Jan. 26, 2012)

A segment closing adjustment under original Cost Accounting Standard 413 must be based on the assets and liabilities of the entire segment, including those transferred to the buyer of the segment, the U.S. Court of Appeals for the Federal Circuit has held, affirming the decision of the U.S. Court of Federal Claims. The Federal Circuit also held that a contractor that sells a segment may satisfy liability for a segment closing adjustment through cost reductions attributable to the pension assets transferred to the successor contractor.

The appeal concerned the circumstances under which a contractor that closes part of its operations must repay the Government for pension contributions that the Government reimbursed under cost-type contracts. Defined-benefit pension plans guarantee set benefits in advance, so companies estimate future pension payments and performance of pension plan investments. Relying on these assumptions, companies determine how much money to invest in a plan.

Original CAS 413.50 regulates the assignment of actuarial gains and losses, the valuation of pension fund assets, and the allocation of pension costs to a contractor's business segments. 4 CFR § 413.50 (1978). That standard also required pension plans to amortize actuarial gains and losses over 15 years. This adjustment process fails, however, when the segment is closed because there are no future periods to adjust pension costs. When a

contractor closes a segment, CAS 413 requires the contractor to determine the difference between the segment's market value and actuarial liabilities. The difference represents "an adjustment of previously determined pension costs." CAS 413.50(c)(12). A segment closing adjustment allocates any surplus or deficiency between the Government and the contractor.

Segment closing adjustments resulted from The DIRECTV Group Inc.'s sale of two segments. The first segment closing occurred when DIRECTV sold defense business units to Raytheon Co. DIRECTV transferred to Raytheon \$5.77 billion in pension assets and \$3.31 billion in pension liabilities, resulting in a net transfer of \$2.46 billion in surplus pension assets. The second segment closing occurred when DIRECTV sold satellite business units to The Boeing Co. DIRECTV transferred to Boeing \$1.84 billion in pension assets and \$1.03 billion in pension liabilities, resulting in a net transfer of \$806.58 million in surplus pension assets. In both transactions, DIRECTV retained a small part of the surplus pension assets.

In response to Government letters stating that DIRECTV was in noncompliance with CAS 413.50(c)(12), DIRECTV submitted a segment closing calculation and a claim for an interpretation of contract terms. The contracting officer issued a final decision concluding that DIRECTV owed segment closing adjustments of \$68.69 million for the Raytheon transaction and \$12.19 million for the Boeing transaction.

DIRECTV filed an action at the COFC seeking declaratory relief and alleging that no segment closing adjustments were required because it transferred all pension plan assets and liabilities to Raytheon and Boeing. The Government filed counterclaims for the segment closing adjustments.

The COFC granted DIRECTV's summary judgment motion, concluding that under original CAS 413, segment closing adjustments must be based on the assets and liabilities of the entire segment, including those transferred to the segment buyers.

*DIRECTV Group, Inc. v. U.S.*, 89 Fed Cl. 302 (2009); 51 GC ¶ 422.

The COFC rejected the Government's argument that absent an express agreement with the Government, DIRECTV could not satisfy its CAS 413 closing adjustment through cost reductions attributable to the segment buyers.

**The Segment**—Affirming the COFC, the Federal Circuit interpreted CAS 413.50(c)(12) as requiring that a segment closing adjustment be based on the assets and liabilities of the entire segment. Original CAS 413.50(c)(12) uses the word “segment” nine times:

If a *segment* is closed, the contractor shall determine the difference between the actuarial 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 determination of the actuarial liability shall give consideration to any requirements imposed by agencies of the United States Government. In computing the market value of assets for the *segment*, if the contractor has not already allocated assets to the *segment*, such an allocation shall be made in accordance with the requirements of paragraph (c)(5)(i) and (ii) of this section. The market value of the assets allocated to the *segment* shall be the *segment's* proportionate share of the total market value of the assets of the pension fund. The calculation of the difference between the market value of the assets and the actuarial liability shall be made as of the date of the event (e.g., contract termination) that caused the closing of the *segment*. If such a date cannot be readily determined, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date. The difference between the market value of the assets and the actuarial liability for the *segment* represents an adjustment of previously-determined pension costs.

4 CFR § 413.50(c)(12) (1978) (Court's emphasis).

In this provision, the definite article “the” precedes the word “segment,” which is never modified by language suggesting less than a full segment. For example, the operative language states that the “difference between the market value of the assets and the actuarial liability for the *segment* represents an adjustment.” Using a definite article, without other limitation on quantity, necessarily describes an entire

segment, the Federal Circuit said, citing *Shum v. Intel Corp.*, 629 F.3d 1360 (Fed. Cir. 2010).

Later changes to CAS 413 support the conclusion that original CAS 413 requires a segment closing adjustment based on the entire segment. Among these changes was a new provision on partial transfers of pension assets and liabilities. While original CAS 413 requires a segment closing adjustment based on the “assets and the actuarial liabilities for the segment,” new CAS 413 requires that the adjustment be “based on the pension plan assets and actuarial accrued liabilities remaining with the contractor.” 48 CFR § 9904.413-50(c)(12)(v) (1996).

**Government's Recoupment Of Excess Payments**—Although CAS governs allocability, i.e., what portions of a cost are assigned to a particular segment or contract, the Federal Acquisition Regulation generally governs whether a party may apply or recover that cost. *Boeing N. Am., Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002); 44 GC ¶ 112; 44 GC ¶ 203; 44 GC ¶ 308. On appeal, the Government claimed that FAR provisions—the Allowable Cost and Payment clause, 48 CFR § 52.216-7(h)(2), and the Credits provision, 48 CFR § 31.201-5—prohibit DIRECTV from satisfying its liability for segment closing adjustments through cost reductions attributable to the pension assets transferred to Raytheon and Boeing as successor contractors.

Since its promulgation in 1983, the Allowable Cost and Payment clause has provided, in relevant part,

The Contractor shall pay to the Government any refunds, rebates, credits, or other amounts (including interest, if any) accruing to or received by the Contractor or any assignee under this contract, to the extent that those amounts are properly allocable to costs for which the Contractor has been reimbursed by the Government.

48 CFR § 52.216-7(h)(2) (2010).

This clause must be inserted in all cost-reimbursement contracts. 48 CFR § 16.307(a)(1) (2010). The clause requires “the Contractor,” in this case DIRECTV, to pay the Government any amount owed. That obligation is implemented by the Credits provision, 48 CFR § 31.201-5, which governs the acceptable forms of payment. It states,

The applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor

shall be credited to the Government either as a cost reduction or by cash refund. See 31.205-6(j) (4) for rules related to refund or credit to the Government upon termination of an overfunded defined-benefit pension plan.

The Federal Circuit held that DIRECTV may rely on Government cost reductions that occurred from DIRECTV's transfer of pension assets to successor contractors. The Court rejected the Government's argument that the word "refund" in the Credits clause requires that payment to come from the original contractor, DIRECTV. The Credits clause allows repayment by either "a cost reduction or a cash refund." Even if the word "refund" is limited only to payment by the originally paid contractor—an issue the Court expressly declined to address—this case addressed a "cost reduction."

The Credits clause does not place such a limit on cost reduction. DIRECTV transferred pension assets to successor contractors, which allowed the Government to obtain the benefits it was entitled to receive as if the transfer never took place. "This is certainly a cost reduction," the Federal Circuit said. As the obligated contractor, DIRECTV caused these cost reductions by transferring the pension assets. The Government cannot collect the segment closing adjustment for a second time simply because these cost reductions occurred as part of a successor contract. This type of payment is allowed by the plain language of the Credits clause, the Court said.

The Government did not dispute that it received more savings from the successor contracts than DIRECTV would owe the Government absent such transfers. The Government did not adequately explain how its proposal for more payment from DIRECTV avoids providing a windfall to the Government, which is prohibited by the CAS statute. See 41 USCA § 422(h)(3).

The Government received the value of DIRECTV's CAS 413 segment closing obligation through a cost reduction from the successor contractors, and in that circumstance "the existence of a Government agreement in which the Government protected its interest in the pension asset surplus through a novation agreement or other means is not material," the Federal Circuit said, quoting the COFC decision. CAS further supports the trial court's holding, by stating that the Government may recover its segment closing adjustment through "any ... suitable technique." 48 CFR § 9903.306(f).

♦ **Note**—Judge Gajarsa agreed that original CAS 413 governed the segment closing, but dissented from the rest of the majority opinion. Judge Gajarsa characterized the majority opinion as "outcome driven," and contrary to "authorizing legislation and the FAR, ... contrary to Supreme Court precedent regarding the interpretation of statutory and regulatory texts, and ... not supported by the factual record."

The CAS Board authorizing legislation, 41 USCA § 422, requires contract price adjustments to "be made ... on *relevant contracts* between the United States and *the contractor*" (dissent's emphasis). The straight-forward import of that language is that cost adjustments must be made on contracts between the Government and the contractor that overcharged the Government, i.e., DIRECTV, the dissent said.

Section 422 unambiguously identifies the party responsible for making the contract price adjustment. Section 422(h)(1) requires that a contractor "agree to a contract price adjustment ... for any increased costs paid to *such contractor* or subcontractor by the United States." Under "elementary grammar" rules, "such contractor" can only mean that the party responsible for the contract price adjustment is the contractor that received increased costs from the Government, here DIRECTV. Similarly, § 422 refers many times to "the contractor," which, under the grammar rules cited by the majority, indicates that the contractor that overcharged the Government must make the segment closing adjustment, the dissent said.

According to the dissent, recovery of the segment closing adjustment through cost reductions on contracts with other contractors should not be allowed without the Government's consent, which was never given. Section 422(h) is silent on how a contractor can agree to a price adjustment and how the Government can recover increased costs from contractors, the dissent said. Section 9903.306 of title 48, Code of Federal Regulations fills that legislative gap by requiring that the Government agree to the method of recovering overcharges by the contractor. The dissent said that summary judgment for DIRECTV was improper because there was no evidence that the Government agreed to the cost reductions instead of a refund.

The dissent said the majority wrongly held that the Credits clause's authorization for a payment through a cost reduction permits DIRECTV to force the Government to accept a cost reduction from Boeing and Raytheon. The Credits provision reference to a "refund" necessarily implicates the recipient of the

funds, i.e., the contractor, and the reference to a “cost reduction” as an alternative to a “refund” implies that both should originate from the same source. Whatever ambiguity remains is resolved by FAR 31.205-6(j)(4). The version of that provision in effect from Sept. 20, 1989, through Dec. 28, 1998, states that whenever “[pension] assets are constructively received by it for any reason, *the contractor* shall make a refund or give a credit to the Government for its equitable share.” 48 CFR § 31.205-6(j)(4) (1990) (dissent’s emphasis). DIRECTV received assets from the pension funds in question, and FAR 31.205-6(j)(4) mandates that “the contractor,” i.e., DIRECTV, “make a refund or give a credit to the Government for its equitable share,” the dissent said.

Although FAR 31.205-6(j)(4) is titled “Termination of defined benefit plans,” the title cannot limit the plain text. Its regulatory history makes clear that it covers more than pension plan terminations. The originally proposed language was broadened to include “*any reversions* to contractors of pension fund assets” (dissent’s emphasis). Because DIRECTV retained a pension surplus in this case, it constructively received surplus assets, and FAR 31.205-6(j)(4) required DIRECTV to give a cost reduction or refund to the Government, the dissent said.

The dissent said that the imprecise cross-reference in the Credits clause to FAR 31.205-6(j)(4) “for rules related to refund or credit to the Government upon termination of an overfunded defined benefit pension plan” does not change the proper interpretation of FAR 31.205-6(j)(4).

The majority criticized the dissent’s interpretation of FAR 31.205-6(j)(4). Under the dissent’s logic, any retained pension asset amounts to a “termination” of the pension under FAR 31.205-6(j)(4). Thus, under this interpretation, if DIRECTV retained \$1.00 of a \$1 billion pension, the pension has been “terminated” and DIRECTV alone must pay the refund. Moreover, unless the Government expressly agreed to the transfer of the other \$999.99 million, DIRECTV would be liable for a segment closing adjustment on the full \$1 billion, even though the subsequent contractor continued the pension with all future amortized adjustments, the majority said.

In the case before the Court, the dissent’s construction would lead to double recovery by the Government of \$273 million—once in the form of a segment closing adjustment, and again in the amortized adjustments by the subsequent contractor.

The majority said that it was “not surprising that neither party requests this outrageous result.”

In response, the dissent said that there is nothing absurd about holding a party to a contract and requiring it to pay when the contract says it must. DIRECTV sold a segment that included an overfunded pension. The sale price “most certainly” reflected the excess funds contained in the pension, most of which are available to the purchaser if the fund is later terminated. Thus, DIRECTV received more for the sale of the segment than it would have if the pension were not overfunded. The Government is entitled to part of that increased sale price. That Boeing and Raytheon will supposedly charge the Government less in the future is irrelevant to the fact that DIRECTV avoided its obligations under the contract, the dissent said.

♦ **Practitioner’s Comment**—The Federal Circuit’s decision in *DIRECTV* highlights the controversy inherent in the segment closure provisions of CAS 413. But before addressing the substance, I make a general observation. The decision and the dissent show a strong characteristic of the Federal Circuit: a meticulous dissection of statutory and regulatory language to arrive at the plain meaning. We saw evidence of this in the Federal Circuit’s decision in *ATK Thiokol, Inc. v. US*, 598 F.3d 1329 (Fed. Cir. 2010), pet. for reh’g denied (July 13, 2010); 52 GC ¶ 129. This decision is another lesson in how the Federal Circuit tackles statutory and regulatory construction.

Regarding the merits of the CAS 413 segment closure analysis, the Federal Circuit has hopefully put to rest the effect of the 1995 CAS 413 rewrite vis-à-vis the original CAS 413. Since the first CAS segment closure case, *Gould, Inc.*, ASBCA 46759, 97-2 BCA ¶ 29254; 39 GC ¶ 468; recon. denied, 98-1 BCA ¶ 29469; 40 GC ¶ 51, the Government has argued that the 1995 rewrite of CAS 413 merely clarifies the preexisting CAS. According to the Government, the CAS 413 rewrite should apply to all contracts subject to CAS 413. The Armed Services Board of Contract Appeals rejected that position in *Gould*, as did the COFC in *Teledyne Inc. v. U.S.*, 50 Fed. Cl. 155 (2001), which the Federal Circuit affirmed. *Allegheny Teledyne Inc. v. U.S.*, 316 F.3d 1366 (Fed. Cir. 2003); 45 GC ¶ 69; cert. denied, *Gen. Motors Corp. v. U.S.*, 540 U.S. 1068 (2003). In *DIRECTV*, the Federal Circuit once again ruled that



the CAS 413 rewrite was not a mere clarification of the preexisting CAS, but rather was a substantive change. 2012 WL 233978, at \*5. Thus, the CAS segment closure adjustment is made based on the CAS that was in effect at the time of any particular contract.

As to the implementation of the segment closure adjustment (i.e., whether the adjustment should have come directly from DIRECTV or could come from contracts under the successors-in-interest—Boeing and Raytheon), the Federal Circuit read CAS 413 in the context of the event that precipitated the segment closure. Per interpretation of the original CAS 413 and the language of the revised CAS 413, the sale of a segment constitutes a segment closure. Under a sale, the Government contracts being performed (and typically associated pension assets and liabilities) transfer from one contractor to a successor-in-interest. In reality, the “segment” continues, just under another name. Thus, the Federal Circuit applied CAS to the practical context and concluded that the parties can effect a cost reduction under CAS 413 through the contracts held by the successors-in-interest. 2012 WL 233978, at \*6–7.

Further, the Federal Circuit issued a ruling that has broader impact for CAS in general. Citing the CAS statute, the Federal Circuit held that the statute prohibits a windfall to the Government. *Id.* at \*7. This affirms a trend of case law from the COFC, *Gen. Elec. Co. v. U.S.*, 84 Fed. Cl. 129 (2009) (“the CAS authorizing legislation makes clear that the CAS ... prohibit the government from receiving a windfall”), and the ASBCA, *Raytheon Co.*, ASBCA 56701, 11-1 BCA ¶ 34735 (citing the CAS statute’s limitation to increased costs in the aggregate and not permitting windfalls); 53 GC ¶ 120. Similarly, the Federal Circuit held in *DIRECTV* that the Government is not entitled to a windfall—here, a double payment for the same event—through reductions on contracts and again as a direct payment under the credits clause. 2012 WL 233978, at \*7.

Given that the dissent is nearly longer than the decision, it cannot go unnoticed. The pension provi-

sions in CAS are admittedly complex, and after counseling and trying cases on CAS 412 and 413 for more than 20 years, they still give me a headache. Thus, the existence of a dissent may be understandable.

Considering the issues as stated in the majority opinion, however, it seems, respectfully, that the dissent may have strayed from the mark. The issues in the case focus on the method of calculating the segment closing adjustment under CAS 413.50(c)(12) and the implementation of that adjustment, if any. *Id.* at \*3. That is a provision unique to CAS 413. The dissent, instead, focuses on the statutory provisions for an adjustment resulting from a CAS noncompliance or change in accounting practice—including the concepts of an affected contract.

Additionally, the dissent suggests that a mandated segment closure accounting under CAS 413 triggers constructive receipt of pension assets under FAR 31.205-6(j). The concept of constructive receipt has been and remains obscure. Although the opinion states that DIRECTV “retained a relatively small portion of the surplus pension assets,” *id.* at \*2, the decision provides no details, and the trial court decision does not include any findings of fact regarding a DIRECTV-retained surplus. *DIRECTV Group, Inc. v. U.S.*, 89 Fed. Cl. 302 (2009). Moreover, the dissent does not address the implications of the Employee Retirement Income Security Act on the concept of constructive receipt. It is, therefore, difficult to draw a nexus to constructive receipt.

The floodgates of CAS 413 segment closure cases seem to be closing. Given the money involved in these cases and the controversy over the meaning and implementation of CAS 413, however, the gates are not likely to shut any time soon.



***This PRACTITIONER’S COMMENT was written for THE GOVERNMENT CONTRACTOR by Paul E. Pompeo, a partner in the Government Contracts practice of Arnold & Porter, LLP. Mr. Pompeo is a past chair of the Accounting, Cost & Pricing Committee of the American Bar Association Section of Public Contract Law.***