The Clause

Boards of Contract Appeals Bar Association

The Clause

Fall, 2006

President's Column by Judge Richard Walters

Let me start out by saying that I consider it a special privilege to serve as the BCABA President for the coming year. As witnessed by all BCABA did during the last year, our Association can make a real difference in terms of the quality of practice before our federal Boards of Contract Appeals. We aim to continue to offer a wonderful array of programming and activities this coming year as well.

Annual Program:

The 2006 BCABA Annual Program, which we held on Friday, September 29, 2006, at the Washington Marriot Hotel, went beautifully. We were amazed with the attendance which, at nearly 140 registrants, significantly exceeded our previous record. The luncheon keynote address, from new GSA Administrator Lurita Doan, was a rare treat. We are grateful to the panel chairs and to their panelists for a stimulating day filled with lively discussions, and to all of you who attended for your thought-provoking questions. The Association owes a huge debt of gratitude to Michele Brown, our immediate Past President, for her unflagging efforts in keeping everything on track for our Annual Program (and for everything else she has done for the past two years). Finally, a special thank you to Holland & Knight's Valli Haas for serving so skillfully as Program Registrar for the second straight year, and to Melody Reis for helping Valli and me with the registration process and with the Program's slide presentations. (*continued on page 2*)

Reflections of a Past President by Anonymous C.P.A., Esq.

Doing volunteer work for the BCABA can be very enhancing, both personally and professionally. Members who are not put off about becoming the president of the BCABA should know that the organization is very democratic in that regard. There have been several youthful presidents (in this article, the term "youthful" is loosely defined as someone in their 30s). In terms of employment, BCABA presidents have come from government agencies, law firms, boards of contract appeals, and even an (*continued on p. 12*)

President:

Judge Richard Walters

VABCA

Vice President:

J. Michael Littlejohn

Akerman Senterfitt

Secretary:

David N. Nadler

Dickstein Shapiro

Treasurer:

Tom Gourley

Corps of Engineers

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President's Column (cont'd)

Trial Practice Seminar:

Our Trial Practice Seminar, "***Effective and Ethical Practice At the Boards of Contract Appeals,"*** which we co-sponsored with The George Washington University Law School, was held this year on Wednesday, October 25, 2006, at the GW Law School Moot Court Room. This first-rate program again was chaired by our current BCABA Vice President, J. Michael ("Mike") Littlejohn, and featured an excellent panel, including: Judge Alexander Younger, Armed Services Board of Contract Appeals; Judge Robert Parker, Vice-Chair, General Services Board of Contract Appeals; Thomas H. Gourlay, Chief Trial Attorney, United States Army Corps of Engineers; and Stephen B. Hurlbut, Shareholder, Akerman Senterfitt Wickwire Gavin. Insightful opening remarks were provided by Professor Frederick J. Lees, the E.K. Gubin Professor Emeritus of Government Contracts Law at GW Law School. This **free** seminar is particularly useful for those just starting out as Government Contracts attorneys who may need practical guidance in how to practice before the Boards, provides written materials with helpful pointers on trial practice, and allows attendees to ask questions of the panel. **NOTE:** *This program has been approved by the Virginia Mandatory Continuing Legal Education Board for 1.5 hours of CLE credit (including 0.5 hours of ethics credit).*

Other Programs in 2007:

The BCABA calendar also will include a Colloquium at GW Law in early Spring 2007, and an Executive Policy Forum in the late Spring for our Gold Member Firm and Government agency lawyers. In addition, we co-sponsor a Judges Reception each year, along with the D.C. Bar and Federal Bar Association, and that always proves to be a special program. Detailed announcements will be issued by e-mail well in advance of each program. In short, there's a lot the BCABA does, and anybody who wants to get involved in planning one or more of our programs, please contact me at (202) 273-6747 or Rich.Walters@va.gov.

(*continued on page 3*)

Bored of Contract Appeals
(a.k.a. The Editor's Column)
Peter A. McDonald
C.P.A., Esq.
(A nice guy . . . basically.)

To begin with, please note the many BCABA activities listed in the President's Column. Also in this issue, we have a comprehensive analysis of estoppel by Karen Manos (Gibson Dunn), and there is an excellent article by Lou Antonacci (Watt Tieder) on the government's potential liability for a prime contractor's advance payments to its subs. Finally, there is an article on the Pension Protection Act of 2006, as well as an anonymous open letter to the membership from a past president.

As usual, there were some articles that were not accepted for publication, such as: "See Rep. Foley's Emails to Pete McDonald – and His Alluring Replies!"; "Discovery in NASA Case Reveals Evidence of UFOs!"; and "Government Motion for Summary Judgment *Sustained*!"

And remember: Don't take all this government contract stuff too seriously.

The Clause:

Another area where you can become involved with BCABA is in this publication. Peter McDonald, our Interim Editor, is happy to publish articles on government contracts topics of any ilk, and, because ***The Clause*** is an on-line publication, no limitations are imposed on article length or numbers of articles. The quality of our articles has been consistently good and, because of its widespread distribution, contributing an article for publication in ***The Clause*** is worthy of your serious consideration. Pete would also appreciate hearing from anyone who would like to assist in editing ***The Clause.*** Pete can be reached at Pete.McDonald@rsmi.com .

The BCABA Website:

Please monitor the BCABA Website for information on future BCABA programs. Because it has been upgraded and is such a "user friendly" site, use of the Website continues to grow. In August 2006, for example, the Website was accessed 15,862 times, or 459 times per day! Our updated online members-only Directory will be posted soon at our website, http://www.bcaba.org. Members will receive from me an email notifying you of the username and password to access the Directory.

Quarterly Meetings:

I invite you to join us at the quarterly meetings of our BCABA Board of Governors, which are scheduled to be held at the offices of Holland & Knight LLP, 2099 Pennsylvania Avenue, N.W., Washington, D.C., on the following dates (all Thursdays): December 14, 2006; March 22, 2007; June 21, 2007; and September 20, 2007. Reservations are needed so that we may make adequate arrangements for the numbers who will attend. If you are unable to join us at the meetings, I encourage you to forward any comments or suggestions you may have to me (or to any of our officers). Again, you may contact me at (202) 273-6747 or Rich.Walters@va.gov.

Richard C. Walters

President

Estoppel Against The Government:

What Does 'Affirmative Misconduct' Have To Do With It?

by
Karen L. Manos[1]

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Twice in the last three years, the Federal Circuit invoked the doctrine of estoppel in the context of a Government contract dispute. Both times, the court stated in dicta, that for estoppel to apply against the Government, the contractor must show "affirmative misconduct" in addition to the traditional elements of estoppel.[2] Decisions by the Court of Federal Claims and agency boards of contract appeals, including, most recently, the ASBCA in *United Technologies Corp.*, *Pratt & Whitney*, (*continued on page 5*)

ADVANCE PAYMENTS FROM PRIME CONTRACTORS TO THEIR SUBS: CAN THE RISK OF NON-PERFORMANCE BE PUSHED ONTO THE GOVERNMENT?

BY

LOUIS B. ANTONACCI

WATT, TIEDER, HOFFAR & FITZGERALD LLP

(Louis B. Antonacci, Esq., is with the firm of Watt, Tieder, Hoffar & Fitzgerald LLP. The views expressed in this article are those of the author and not of Watt, Tieder, Hoffar & Fitzgerald LLP.)

A little-known loophole exists in the laws surrounding the general prohibition of advance payments in federal government contracts. The loophole is applicable only to cost-reimbursable contracts, and is caused by the intersection of the statutes, regulations and case law regarding advance payments and allowable costs. The situation that this article addresses does not involve advance payments by the government, but rather by a prime contractor to its subcontractor with the contracting officer consistently approving such payments as an allowable cost. The concern arises when a contracting officer consistently characterizes, as an allowable cost, advance payment arrangements between one of its cost-reimbursable contractors and their subcontractor. If that subcontractor fails to perform and subsequently fails to repay the unliquidated balance of the advance payment, the prime contractor may be able to claim successfully that the unliquidated balance is an allowable cost for which it should be reimbursed by the Government.

This unusual situation really happened, and is most likely to recur in overseas locations where large, U.S.-based prime contractors are forced to utilize foreign subcontractors that are thinly capitalized. To shift the ultimate risk of non-performance onto the Government, these prime contractors may have the contracting officer explicitly approve advance payments to their foreign subcontractors as allowable costs. The prime contractor may do this to the point where it becomes an accepted practice. As this article will demonstrate, the Government may be left "holding the bag" in situations of non-performance, even when the proper procedures for assuming such risks have not been followed.

I. Statutory Framework Intends to Minimize Risk

Advance payments are the least preferred method of financing U.S. Government contracts. Generally speaking, 31 U.S.C. §3324(a) expressly prohibits advance payments: "Except as provided in this section, a payment under a contract to provide a service or deliver an article for the United States Government may not be more than the value of the service already provided or the article already delivered." The Government Accountability Office (GAO) has explained that

> [t]he primary purpose of 31 U.S.C. §3324 is to protect the Government against the risk of non-performance— "to preclude the possibility of loss to the Government in the event a contractor — after receipt of payment —should fail to perform his contract or refuse or fail to refund moneys advanced."[1]

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Estoppel Against The Government (cont'd):

have started applying this dicta as if "affirmative misconduct" were now an established element of estoppel.[3] But is "affirmative misconduct" really a prerequisite for applying estoppel against the Government in the context of a Government contract dispute? And, if so, how does that square with the long line of cases, including binding precedent by the Federal Circuit and its predecessor courts, applying estoppel against the Government without any mention of affirmative misconduct?

Part of the blame may lie with the Government contracts bar for failing to heed the sound admonition of Professors Nash and Cibinic that equitable estoppel "is not a panacea and should be used only where the requisite elements are present."[4] But a more fundamental problem is the failure—by both litigants and Government contracting tribunals—to recognize that "affirmative misconduct" was adopted as a circumstance justifying an exception to the familiar rule that the Government is not bound by the *unauthorized* acts of its agents; it has no applicability whatsoever to cases involving *authorized* acts.

The Government Is Bound by the Authorized Acts of Its Agents

The Supreme Court long has held that "[d]ifferent rules prevail in respect to the acts and declarations of public agents from those which ordinarily govern in the case of mere private agents."[5] In particular, while private parties may in many circumstances be bound by the unauthorized acts and declarations of their agents, the Government is not bound by the unauthorized acts of its agents.[6] An important, but occasionally overlooked, corollary to this maxim is that the Government *is* bound by the acts, omissions and declarations of its agents acting within the scope of their authority.[7] For example, in *Hollerbach v. U.S.*, an early differing site conditions case, the Supreme Court refused to permit the Government to assert a position contrary to an affirmative representation made in the contract.[8]

These rules apply regardless of whether the Government is acting in its proprietary or sovereign capacity. The difference is that when the Government acts in its proprietary capacity, its agents have authority to waive or modify contractual provisions.[9] For example, the Government has been held to have waived its contractual rights in many circumstances, such as when the contractor relies on the Government's delay in terminating a contract for default[10] or the CO's apparent acceptance of the contractor's non-specification work.[11] Likewise, under the rule of finality, the Government is bound by the contractual acts of its authorized officials even if, in hindsight, the official's decision was erroneous.[12] These principles are consistent with the Supreme Court's repeated admonition that "[w]hen the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals."[13]

Until relatively recently, Government contract estoppel cases fit neatly within these well-settled principles. That is, the Federal Circuit and its predecessor courts consistently applied estoppel against the Government when the course of conduct or representation on which the plaintiff relied was by an officer or agent of the U.S. acting within the scope of his or her authority, and the plaintiff established the four "traditional" elements of estoppel: (1) the Government knew the facts, (2) the Government intended that its conduct be acted upon or acted in such a way that the contractor had a right to believe the Government so intended, (3) the contractor was not aware of the true facts and (4) the contractor detrimentally relied upon the Government's conduct.[14] In an extension of estoppel principles, both the Court of Claims and agency boards of contract appeals also held that the Government cannot retroactively disallow costs, or retroactively disapprove a contractor's cost accounting practices when the contractor detrimentally relied on the Government's acquiescence or approval.[15] As recently as March 2002, the Armed Services Board of Contract Appeals held

Estoppel Against The Government (cont'd):

that a contractor is entitled to prior authoritative notice before the Government may start disallowing a cost that previously was consistently allowed.[16]

In applying these settled principles prior to the Federal Circuit's dictum in *United Technologies Corp.*, none of the Federal Circuit or Court of Claims cases—which are supposed to be binding precedent[17]—required a showing of, or even mentioned, affirmative misconduct. Federal Circuit Rule 35 provides that only the en banc court may overrule a binding precedent.[18]

The Government Is Not Bound by the Unauthorized Acts of Its Agents

The Supreme Court cases that have considered—but never applied—estoppel against the Government have typically involved claims for public benefits of one sort or another where the claimant detrimentally relied on a misrepresentation by a Government official. In marked contrast to the typical situation in a Government contracts case, the Government officials on whose declarations the plaintiffs in these cases relied had no delegated authority, and the application of estoppel would have barred the Government from enforcing federal law by requiring the Government to either pay money in violation of a statute, or grant a public benefit contrary to statutory eligibility criteria. In that context, the Supreme Court has consistently and understandably refused to apply estoppel against the Government. As the Court explained in *Heckler v. Community Health Srvcs.*, 467 U.S. 51, 60 (1984), "When the government is unable to enforce the law because the conduct of its agents has given rise to an estoppel, the interest of the citizenry as a whole in obedience to the rule of law is undermined. It is for this reason that it is well settled that the government may not be estopped on the same terms as any other litigant."

However, even in that context—when applying estoppel would result in the Government being bound by the unauthorized acts of its agents—the Supreme Court has refused to establish a per se rule that estoppel never applies against the Government. The Court came closest to establishing a per se rule in *Office of Personnel Management v. Richmond*,[19] involving a disabled former Government employee who relied on inaccurate advice from a Navy employee relations official about how much income he could receive and still continue to draw disability payments. Relying on the erroneous advice, Richmond accepted additional part-time work, earning enough to become disqualified for disability payments. He appealed OPM's denial of benefits, arguing that OPM was estopped from denying benefits by the erroneous advice of the employee relations official. The Supreme Court rejected Richmond's argument, but declined to establish a blanket rule that estoppel never applies against the Government. Rather, the Court expressly limited its holding to claims for money from the Public Treasury, stating that, for those claims, the Appropriations Clause of the Constitution provides an "explicit rule of decision."[20] In so holding, the Court specifically declined to address whether there were any "extreme circumstances that might support estoppel in a case not involving the payment from the Treasury."[21] Importantly, however, the *Richmond* decision makes clear that it addresses the application of estoppel when the agent was *not* acting within the scope of his authority. The Court stated:

> From our earliest cases, we have recognized that equitable estoppel will not lie against the Government as it lies against private litigants. In *Lee v. Munroe & Thornton*, 7 Cranch 366, 3 L.Ed. 373 (1813), we held that the Government could not be bound by the mistaken representations of an agent *unless it were clear that the representations were within the scope of the agent's authority*.
>
> * * * *
>
> The principles of these and many other cases were reiterated in *Federal Crop Ins. Corporation v. Merrill*, 332 U.S. 380 (1947), the leading case in our modern line of estoppel decisions.[22]

<u>Estoppel Against The Government (cont'd):</u>

Genesis of 'Affirmative Misconduct' Language

The "affirmative misconduct" language stems from a series of decisions involving applications for U.S. citizenship, in which the Supreme Court expressly left open the question of whether affirmative misconduct could estop the Government from enforcing immigration laws.[23] As the Court in Richmond observed:

> The proposition about which we did not "stop to inquire" in [the first of these immigration cases] has since taken on a life of its own. Our own opinions have continued to mention the possibility, in the course of rejecting estoppel arguments, that some type of "affirmative misconduct" might give rise to estoppel against the Government.[24]

While only mentioned as a possibility in the Supreme Court's opinions, all of the federal circuit courts of appeals have concluded that affirmative misconduct *can* give rise to estoppel against the Government for the unauthorized acts of its agents. However, apart from the Federal Circuit's recent dicta, no federal appellate court has suggested, much less held, that affirmative misconduct is necessary to establish estoppel when the Government officials acted within the scope of their authority. Moreover, at least three federal circuits have expressly recognized that estoppel routinely applies against the Government when (1) the traditional elements of estoppel are met, (2) the Government is acting in its proprietary rather than sovereign capacity and (3) the Government agents acted within the scope of their authority.[25]

Where Did the Federal Circuit Go Wrong?

The Federal Circuit has considered estoppel in the context of a Government contracts dispute in four cases since *Richmond.* In *JANA, Inc. v. U.S.*, a decision issued shortly after *Richmond*, the Federal Circuit questioned whether "the defense of estoppel is still available against the government" and whether the Federal Circuit's "contract precedent prior to *Richmond* is still valid."[26] The *JANA* court ultimately did not decide this question because the court found that the plaintiff failed to satisfy even the pre-*Richmond* "contract precedent."[27] Two years later in *Burnside-Ott Aviation Training Ctr, Inc. v. U.S.*, the Federal Circuit seemed to recognize the continued vitality of estoppel in Government contract cases by distinguishing between claims for payment of money contrary to a statutory appropriation—or entitlement contrary to statutory eligibility criteria—and claims or defenses based solely on contract.[28] In reversing the lower court's decision that estoppel can never apply against the Government for monetary claims, the Federal Circuit held that, because the contractor's claim was based on its Government contract rather than on a statutory entitlement, "neither the holding nor analysis in *Richmond* is applicable to this case, and Burnside-Ott's equitable estoppel claim is not barred as a matter of law because of *Richmond*."[29]

In *Rumsfeld v. United Technologies Corp.*, the Federal Circuit stretched to address an estoppel issue not yet considered by the ASBCA and gratuitously advised the board that on remand:

> Adjudication of the estoppel issue must proceed under the "well settled [rule] that the Government may not be estopped on the same terms as any other litigant." *Heckler v. Cmty. Health Servs. of Crawford County, Inc.*, 467 U.S. 51, 60 (1984). Beyond a mere showing of acts giving rise to an estoppel, [the contractor] must show "*affirmative misconduct* [as] a prerequisite for invoking equitable estoppel against the government." *Zacharin v. United States*, 213 F.3d 1366, 1371 (Fed. Cir. 2000) [emphasis added].[30]

The Federal Circuit repeated this assertion, once again in dicta, in *United Pacific Ins. Co. v.*

Estoppel Against The Government (cont'd):

Roche, stating, "Our own precedent dictates 'that if equitable estoppel is available at all against the government some form of affirmative misconduct must be shown in addition to the traditional requirements of estoppel.' *Zacharin v. U.S.*, 213 F.3d 1366, 1371 (Fed. Cir. 2000)."[31]

Zacharin, the precedent on which both *United Technologies* and *United Pacific Ins.* rely, is not a Government contracts case and did not purport to overrule the Federal Circuit's "contract precedent." *Zacharin* was an appeal of a Court of Federal Claims decision dismissing a federal employee's patent infringement suit on the basis that the patented invention was on sale more than one year prior to the filing of the patent application. The employee argued unsuccessfully that the Government should be estopped from raising the on-sale-bar because the Army attorneys who filed his patent application were aware of the sales, but filed the application anyway. The lower court rejected the employee's argument for two reasons: (1) the plaintiff failed to establish the traditional elements of estoppel; and (2) in any event, a claim for money contrary to a statute is barred by *Richmond*. The Federal Circuit agreed with the lower court's holding that the Government may not be estopped from invoking the on-sale bar as a defense, but for the different reason that there was no evidence of affirmative misconduct. The court stated:

> While the Supreme Court has not squarely held that affirmative misconduct is a prerequisite for invoking equitable estoppel against the Government, this court has done so, *see Henry v. United States*, 870 F.2d 634, 637 (Fed. Cir. 1989); *Hanson v. Office of Personnel Management*, 833 F.2d 1568, 1569 (Fed. Cir. 1987), as has every other court of appeals, *see Tefel v. Reno*, 180 F.3d 1286, 1303 (11th Cir. 1999) (citing cases).[32]

Army attorneys filing a patent application for a civil servant plainly have no authority to modify or waive the statutory patent requirements. The two Federal Circuit decisions relied on by the *Zacharin* court similarly involved agents with no delegated authority. In *Henry v. U.S.*, the Federal Circuit held that the Internal Revenue Service was not estopped from raising a statute of limitations defense against a taxpayer's refund suit because the IRS agent's erroneous advice did not constitute the type of affirmative misconduct required as an element of estoppel against the Government.[33] In *Hanson v. OPM*, the court held that the Government was not estopped from denying the plaintiff a civil service retirement annuity because the federal official's good faith, but erroneous, interpretation of the statutes on which the plaintiff relied was not affirmative misconduct.[34] *Tefel v. Reno* collects "affirmative misconduct" cases from all of the federal circuits, none of which involved a Government agent acting within the scope of his or her employee. Because neither *Zacharin* nor any of the cases it cited involved agents acting within the scope of their authority, the *Zacharin* court may not have perceived any need to distinguish the facts of that case from cases in which the plaintiff sought to hold the Government liable for acts or declarations of its agents acting within the scope their authority.

It is far less clear why the *United Technologies* and *United Pacific Ins.* courts failed to recognize this distinction, particularly given the *JANA* court's awareness of the Federal Circuit's "contract precedent." Unfortunately for practitioners, judicial mistakes become worse with repetition because the more removed a talismanic holding is from both the cases on which it relies and the cases it sub silentio overrules, the less able a new court will be to correct (or even recognize) the mistake. Moreover, lower tribunals, in struggling to support the superior court's holding, will only exacerbate the initial mistake, as happened with the ASBCA's decision on remand in *United Technologies*.[35]

Estoppel Against The Government (cont'd):

The ASBCA's Decision in *United Technologies Corp.*

At issue in *United Technologies* was whether revenue share payments that UTC paid pursuant to its collaboration agreements with foreign parts suppliers constituted a "cost" that must be included in the contractor's indirect cost allocation bases. The ASBCA initially concluded that the payments were not a cost for parts and need not be included in the indirect cost allocation bases.[36] The Federal Circuit disagreed, holding that the parts were sold to the suppliers and the revenue share payments represented the cost of obtaining the parts. The Federal Circuit vacated the board's decision on entitlement and remanded to the board to address the estoppel issue raised by UTC. On remand, the ASBCA found that UTC had not met the traditional elements of estoppel. In particular, the board was not convinced that the Government knew the facts or that UTC detrimentally relied on the Government's conduct.[37] Had the board's opinion ended there, the case would be unexceptional. Regrettably, the board proceeded to address the "affirmative misconduct element."

Although finding that the Federal Circuit's dictum about affirmative misconduct was not the law of the case, the ASBCA nevertheless tried valiantly to find a legal basis to support the Federal Circuit's guidance. UTC argued that "the affirmative misconduct standard conflicts with the tenet that the government must be treated the same as a private litigant when acting in its proprietary capacity as a contracting party." In response, the ASBCA noted that *Zacharin* was factually similar to a proprietary case, while *United Technologies* was factually distinct from a private contract case. With regard to the first point, the ASBCA stated:

> While *Zacharin* was not a contract case, it did involve actions by the Government that were of a proprietary or business nature inasmuch as the underlying issue involved whether the Government was required to reimburse appellant for its use of a patented invention.[38]

On the other hand, the ASBCA found that the "government's performance of contractual duties in conjunction with CAS rules and regulations" implicate "governmental regulatory rights and obligations [that] are not applicable to contracts between private litigants, and certainly not in the context of equitable estoppel."[39] Accordingly, the ASBCA found no conflict between the Federal Circuit's guidance and the Supreme Court's application of general contract law principles when the Government is acting in its proprietary capacity.

With due deference to the ASBCA, the critical distinguishing fact in *Zacharin* was not whether the Government was acting in a sovereign or proprietary capacity, but whether the Army attorneys who filed the plaintiff's patent application had authority to waive the Government's rights. *Zacharin* stands for the unremarkable proposition that absent affirmative misconduct, the Government is not bound by the unauthorized acts of its agents. In contrast to the Army attorneys in *Zacharin*, who had no delegated authority, it *is* within the authority of an administrative contracting officer to determine whether a contractor's cost accounting practices comply with the Cost Accounting Standards.

Conclusion

Affirmative misconduct is not and never has been a condition prerequisite for applying estoppel against the Government so long as the Government agents were acting within the scope of their authority. The Federal Circuit's recent dicta to the contrary directly conflicts with the binding "contract precedent" of the Federal Circuit and its predecessor courts. While other federal circuits

Estoppel Against The Government (cont'd):

have recognized affirmative misconduct as an exception to the rule that the Government is not bound by the unauthorized acts of its agents, the Federal Circuit's dicta has instead created a Government contracts exception to the rule that the Government is bound by the acts of its agents acting within the scope of their authority.

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Endnotes

1 Karen L. Manos is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher LLP. Ms. Manos is the author of GOVERNMENT CONTRACT COSTS & PRICING, © 2004 Thomson/West.

2 See *United Pacific Ins. Co. v. Roche*, 401 F.3d 1362, 1366 (Fed. Cir. 2005); *Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361, 1377 (Fed. Cir. 2004).

3 See *Die Casters Int'l Inc. v. U.S.*, 67 Fed. Cl. 362, 383 (2005); *General Electric Co. v. U.S.*, 60 Fed. Cl. 782, 797 & n.11 (2004); *DeMarco Durzo Dev. Co. v. U.S.*, 60 Fed. Cl. 632, 637-38 (2004); *Ervin & Assocs., Inc. v. U.S.*, 59 Fed. Cl. 267, 297 (2004), aff'd, 120 Fed. Appx. 353 (Fed. Cir. 2005); *Capital Properties, Inc. v. U.S.*, 56 Fed. Cl. 427, 436 (2003); *United Technologies Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., slip op. at 44-47 (ASBCA May 12, 2006); *RGW Communications, Inc., d/b/a Watson Cable Co.*, ASBCA Nos. 54495 et al., 05-2 BCA ¶ 32,972; *Kearfott Guidance & Navigation Corp.*, ASBCA Nos. 49271 et al., 04-2 BCA ¶ 32,757, recons. denied, 05-1 BCA ¶ 32,845.

4 "Equitable Estoppel: Still Hanging in There," 6 N&CR ¶ 31.

5 *Whiteside v. U.S.*, 93 U.S. 247, 256 (1876).

6 See, e.g., *Federal Crop Ins. Corp. v. Merrill*, 332 U.S. 380 (1947).

7 See, e.g., *Cooke v. U.S.*, 91 U.S. 389, 398 (1875); see also *P.I.O. GmbH Bau Und Ingenieurplanung v. International Broadcasting Bureau*, GSBCA No. 15934-IBB, 04-1 BCA ¶ 35,592; *URS Consultants*, IBCA No. 4285-2000, 02-1 BCA ¶ 31,812; *Folk Constr., Inc.*, ENGBCA Nos. 5839 et al., 93-3 BCA ¶ 26,094; *Mick DeWall Constr.*, PSBCA No. 2580, 91-3 BCA ¶ 24,180; *Bell Helicopter Co.*, ASBCA No. 17776, 74-1 BCA ¶ 10,411.

8 *Hollerbach v. U.S.*, 233 U.S. 165, 177 (1914).

9 *Branch Banking & Trust Co. v. U.S.*, 96 F. Supp. 757, 766 (Ct. Cl. 1951); accord *Broad Avenue Laundry & Tailoring v. U.S.*, 681 F.2d 746, 747-48 (Ct. Cl. 1982); *Manloading & Mgt. Assoc.*, Inc. v. U.S., 461 F.2d 1299, 1303 (Ct. Cl. 1972).

10 See, e.g., *Precision Dynamics, Inc.*, ASBCA Nos. 41360 et al., 97-1 BCA ¶ 28,722.

11 See *Miller Elevator Co. v. U.S.*, 30 Fed. Cl. 662, 688-89 (1994).

12 See, e.g., *Decker & Co. v. West*, 76 F.3d 1573, 1583 (Fed. Cir. 1996); accord *MPR Assocs., Inc.*, ASBCA No. 54689, 2005 WL 2840533 (Oct. 27, 2005); *Honeywell Federal Sys., Inc.*, ASBCA No. 39974, 92-2 BCA ¶ 24,966.

13 *Mobil Oil Exploration and Producing Southeast, Inc. v. U.S.*, 530 U.S. 604, 607 (2000).

14 See *USA Petroleum Corp. v. U.S.*, 821 F.2d 622, 627 (Fed. Cir. 1987); *American Electronic Lab., Inc. v. U.S.*, 774 F.2d 1110, 1113 (Fed. Cir. 1985); *Broad Avenue Laundry & Tailoring v. U.S.*, 681 F.2d 746, 749 (Ct. Cl. 1982); *Emeco Indus., Inc. v. U.S.*, 485 F.2d 652, 657 (Ct. Cl. 1973); *Manloading & Mgt. Assoc., Inc. v. U.S.*, 461 F.2d 1299, 1303 (Ct. Cl. 1972).

15 See *Litton Systems, Inc. v. U.S.*, 449 F.2d 392, 401 (Ct. Cl. 1971); *Falcon Research & Dev. Co.*, ASBCA No. 19784, 77-1 BCA ¶ 12,312; *Symetrics Eng'g Corp.*, NASBCA No. 1270-20, 74-1 BCA ¶ 10,553; *Sanders Assocs., Inc.*, ASBCA No. 15518, 73-2 BCA ¶ 10,055; *AC Electronics Div., General Motors Corp.*, ASBCA No. 14388, 72-2 BCA ¶ 9736; *Penninsular Chem Research, Inc.*, ASBCA No. 14384, 71-2 BCA ¶ 9066; *Wolf Research & Dev. Corp.*, ASBCA No. 10913, 69-2 BCA ¶ 8017.

16 *Lockheed Martin Western Dev. Labs.*, ASBCA No. 51452, 02-1 BCA ¶ 31,803.

17 Decisions from the former Court of Claims are binding precedent until and unless overturned by the Federal Circuit sitting en banc. See *South Corp. v. U.S.*, 690 F.2d 1368, 1369 (Fed. Cir. 1982). Likewise, a panel is bound by the holding of another panel unless overturned by the en banc court. See *Vas-Cath Inc. v. Mahurkar*, 935 F.2d 1555, 1563 (Fed. Cir. 1991).

18 See Fed. Cir. R. 35(a)(1) (2006).

19 *OPM v. Richmond*, 496 U.S. 414, 419 (1990).

20 496 U.S. at 424.

21 496 U.S. at 434.

22 496 U.S. at 419-20 (emphasis added).

23 See *INS v. Miranda*, 459 U.S. 14, 19 (1982) (per curium); *INS v. Hibi*, 414 U.S. 5, 8 (1973) (per curiam); *Montana v. Kennedy*, 366 U.S. 308, 315 (1961).

24 *Richmond*, 496 U.S. at 421.

25 See *Penny v. Giuffrida*, 897 F.2d 1543, 1546-47 (10th Cir. 1990); *U.S. v. Killough*, 848 F.2d 1523, 1526 (11th Cir. 1988); *U.S. v. Georgia-Pacific Co.*, 421 F.2d 92, 100-101 (9th Cir. 1970).

26 *JANA, Inc. v. U.S.*, 936 F.2d 1265, 1270 (Fed. Cir. 1991).

27 Id.

28 *Burnside-Ott Aviation Training Ctr, Inc. v. U.S.*, 985 F.2d 1574 (Fed. Cir. 1993).

29 985 F.2d at 1581.

30 *Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361, 1377 (Fed. Cir. 2003).

31 *United Pacific Ins. Co. v. Roche*, 401 F.3d 1362, 1366 (Fed. Cir. 2005).

32 *Zacharin v. U.S.*, 213 F.3d 1366, 1371 (Fed. Cir. 2000).

33 *Henry v. U.S.*, 870 F.2d 634, 637 (Fed. Cir. 1989).

34 *Hanson v. OPM*, 833 F.2d 1568, 1569 (Fed. Cir. 1987).

35 *United Technologies Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., slip op. (May 12, 2006).

36 *United Technologies Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., 01-2 BCA ¶ 31,592, rev'd sub nom., *Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361 (Fed. Cir. 2003), cert. denied, 540 U.S. 1012 (2003).

37 *United Technologies Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., slip op. at 35-40.

38 Id. at 44.

39 Id. at 45.

Reflections of a Past President (cont'd):

accounting firm.

Becoming the president is not particularly difficult. You volunteer. After serving in subordinate officer positions for a couple of years, it finally becomes your turn to be the president. However, being an officer is a completely different responsibility than serving a three-year term on the Board of Governors. This is because officers are responsible for the day-to-day activities of the BCABA, while the members of the Board of Governors only meet quarterly. During such meetings, the officers bring the Board up-to-date on progress made for approved activities, as well as preparations for future functions. Of course, at the quarterly meetings officers (particularly the president) are subject to questioning by the Board.

The nine-member Board of Governors officially oversees the activities of the president, but as a practical matter almost any reasonable request a president makes is routinely approved. One constraint is that approval by the Board of Governors is required for all expenditures exceeding $500, but the policy of the BCABA has always been to let the current president 'drive the train.' This policy allows a president much freedom of action in doing what he or she believes needs to be done. In short, whatever initiatives a president wants to pursue almost invariably receive the Board's approval.

The BCABA is essentially composed of three interest groups: the judges; the law firms; and the government attorneys. The views of these three groups of practicing attorneys on public contract law matters do not always coincide, and it is on such occasions that the job of the president becomes very interesting. Essentially, the president gets pulled in different directions. At times, reconciling the divergent goals of these groups can cause them to have adversarial positions on matters, which occasionally makes the president's role more, shall we say, diplomatically challenging.

In furthering the activities of the BCABA, the president also works with the entire membership, not just the prominent leaders of the profession. It takes much time and effort to ensure that appropriate arrangements are made so that things get done, and a day does not pass that doesn't require some detail to be attended to. Because the president has many demands on his or her time, it is not possible to do everything by oneself. Accordingly, the president is forced to rely on the goodwill of others. The success or failure of a president's term is directly related to how much support for BCABA activities they are able to engender. That said, past presidents are a particularly rich source of advice and assistance on just about any matter (after all, they've all been there). To my pleasant surprise, when I was the president virtually all of them willingly gave of their time to assist me on a wide variety of matters. That tradition continues.

This leads to a somewhat related observation. All BCABA presidents have been very close to the membership, and this is in stark contrast to any other national, state or even smaller sized county bar association. There is a good reason why this is so. Because BCABA members are all interested in public contract law issues, there is a unity of focus throughout the organization. Accordingly, the BCABA president has subject matter rapport with every member, unlike the presidents of national, state or county bar associations who are typically older, prestigious practitioners who have little in common with their membership.

Being the president of the BCABA can be a very worthwhile experience, and I highly recommend it to all. I especially recommend it to younger practitioners because they can get a career-enhancing experience and early visibility in the profession.

After having done all that work, it is not hard to understand why wearing the permanent gold name badge given to past presidents is a distinct honor that each of them greatly values.

Advance Payments from Prime Contractors to Their Subs (cont'd):

The policy driving the general prohibition on advance payments is a desire to minimize the Government's risk of non-performance by its contractors. The reasoning is fairly simple: if the contractor must provide goods or services to the Government before the Government pays the contractor for those goods or services, then the Government assumes little or no risk of non-performance by that contractor.

There are, however, various statutory exceptions to 31 U.S.C. §3324. The Federal Property and Administrative Services Act of 1949[2] and the Armed Services Procurement Act[3] authorize advance, partial, progress or other payments, not to exceed the unpaid contract price, under contracts for property and services.[4] Both of these statutes provide that advance payments may be made only if (1) the agency head determines that advance payments are in the public interest, and (2) adequate security is provided.

II. The FAR and Advance Payments

The Federal Acquisition Regulation (FAR) implements the statutory limitations on advance payments, cited above, and further prescribes the standards for use of advance payments by many federal agencies. FAR 32.102 defines advance payments:

> Advance payments are advances of money by the Government to a prime contractor before, in anticipation of, and for the purpose of complete performance under one or more contracts. They are expected to be liquidated from payments due to the contractor incident to the performance of the contracts. Since they are not measured by performance, they differ from partial, progress, or other payments based on the performance or partial performance of a contract. *Advance payments may be made to prime contractors for the purpose of making advance payments to subcontractors*.[5]

FAR 32.4 sets forth the policies and procedures for advance payments on prime contracts and subcontracts. FAR 32.402 (b) provides that

> [a]dvance payments may be provided on any type of contract; however, the agency shall authorize advance payments sparingly…advance payment is the least preferred method of contract financing (see 32.106) and generally they should not be authorized if other types of financing are available in reasonable amounts.[6]

FAR 32.402 (c) elaborates on how an advance payment may be made:

> (c) If statutory requirements and standards for advance payment determinations are met, the contracting officer shall generally recommend that the agency authorize advance payments.
>
> (1) The statutory requirements are that—
>
> (i) The contractor gives adequate security;
>
> (ii) The advance payments will not exceed the unpaid contract price (see 32.410 (b), subparagraph (a)(2)); and
>
> (iii) The agency head or designee determines, based on written findings, that the advance payment—

Advance Payments from Prime Contractors to Their Subs (cont'd):

(A) Is in the public interest (under 32.401 (a) or (b)); or

(B) Facilitates the national defense (under 32.401 (c))…[7]

It is clear from these provisions that while advance payments may be permissible in certain situations, contracting officers must obtain prior approval from their agency head (or their designee) before making an advance payment to a contractor.

III. Advance Payments and Unauthorized Commitments

There are no reported cases that address the situation where the Government expressly approves advance payments by a prime to its subcontractor, and the prime contractor subsequently seeks to recover the unliquidated portion of those advance payments from the Government. However, the Court of Appeals for the Federal Circuit (CAFC) has addressed the issue of unauthorized commitments in the context of advance payments. In *Johnson Management Group CFC, Inc. v. R. Martinez*, the CAFC held that a contracting officer does not have the authority to accept a contractor's purchase of equipment needed to execute performance as fulfillment of unliquidated portions of advance payments.[8] The court held that such acceptance essentially turned these advance payments into gifts. Because the Government is not bound by the acts of its agents acting outside of the scope of their authority, this contract provision was unenforceable.[9] The contract in question was a firm fixed-price services contract.[10]

IV. Government Cannot Retroactively Disallow Costs It Has Consistently Accepted

On one level, government contracts can be distinguished as fixed-price or cost-reimbursable. When a contractor enters into a fixed-price contract, the contractor promises to perform at a fixed-price and bears the responsibility for increased costs of performance.[11] Cost-reimbursable contracts, on the other hand, provide for payment of allowable incurred costs to the extent prescribed in the contract.[12] FAR 31.2 sets forth limitations on determining the allowability of contract costs; FAR 31.205 specifically addresses the allowability of contract costs. For example, FAR 31.205-3 disallows bad debts as a reimbursable contract cost. The section reads: "[b]ad debts, including actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims, and any directly associated costs such as collection costs, and legal costs are unallowable."[13]

While the Government has the burden of proof in establishing the unallowability of a cost (by operation of specific contract provision or regulation),[14] it is well established that where the Government has consistently accepted and allowed a cost in the past, the Government may not retroactively disallow that cost even if it meets the initial burden.[15] In *Appeal of Lockheed Martin Western Development Laboratories*, a case involving a cost-reimbursable contract, the contractor appealed the final decision of the contracting officer disallowing costs for a Settling-in-Allowance (SIA) paid to employees who relocated overseas or returned to the United States. The Government argued that the SIA should be disallowed pursuant to FAR 31.205-35.[16] The contractor argued that the costs should be allowed because they were part of its long-standing compensation policy, and that they had been approved and accepted by the Government on numerous previous occasions.[17] The Board held that, although the Government met its burden of proving that the SIA was unallowable per FAR 31.205-35, the Government nonetheless was not entitled to disallow those costs because the contractor had included those costs in its proposals for years without the Government objecting.[18]

Advance Payments from Prime Contractors to Their Subs (cont'd):

V. Payment from Prime to Sub Does Not Require Regulatory Approval

Characterizing advance payments that flow from a prime contractor to a subcontractor as allowable costs does not violate the prohibitions or requirements of 31 U.S.C. §3324, 10 U.S.C. §2307, or FAR 32.4. Advance payments are defined as "advances of money *by the Government* to a prime contractor" for work that has not yet been performed.[19] There is no prohibition on federal prime contractors advancing money to their subcontractors.

VI. Express Approval Could Push Risk of Non-Performance onto the Government

In light of the foregoing, a contracting officer's consistent characterization of advance payments made by a cost-reimbursable contractor to its subcontractors as allowable costs could push the risk of non-performance by those subcontractors onto the Government. While such approvals are not a violation of the plain meaning of the relevant statutes or regulations, it potentially exacerbates precisely what the statutes seek to mitigate.

If such a situation were to arise, the Government would have the initial burden of proving that these costs were unallowable.[20] The Government could characterize the unliquidated balance as a bad debt and therefore unallowable under FAR 31.205-3. This section is quite broad, covering any actual or estimated loss arising from an "uncollectible accounts receivable due from customers and other claims." While there is no case law on this point, a court or board may find that the unliquidated balance of an advance payment falls within the meaning of FAR 31.205-3.

While the Government's ability to point to a provision of law or contract is a necessary condition of proving that a cost is unallowable, that alone is not sufficient.[21] If the contractor had received written authorization from the contracting officer characterizing the advance payment as allowable prior to making the payment, then a court may characterize that authorization as an advance agreement[22] and interpret it as part of the contract,[23] upsetting it only in the case of ambiguity.[24] The Government would have to demonstrate either that its authorization was ambiguous because it did not authorize the potential loss resulting from non-performance of the subcontractor, or that such authorization was beyond the authority of the contracting officer and therefore not binding on the Government.

The Government's first argument is that it never expressly assumed the risk of loss in the event that one of the non-performing subcontractors failed to repay the unliquidated balance of an advance payment. That is to say, the Government never assumed the risk of any bad debts such as these. This would, of course, be a very fact-specific inquiry, but absent any express disclaimer such an argument would likely appear disingenuous. There is no other apparent purpose for the Government's authorization of advance payments except for the Government to assume the ultimate risk of liability in the event of non-repayment. Indeed, because there are no statutory or regulatory limitations on a contractor's ability to advance money to its subcontractors, the contractor could have simply advanced the money without requesting that the Government characterize such payment as an allowable cost. Ostensibly, the only reason for requesting such authorization is to shift the risk of loss onto the Government, and absent any compelling facts to which the Government could point in making its case, it seems unlikely that this argument would prevail.

V. Express Approval Could Push Risk of Non-Performance onto the Government

In light of the foregoing, a contracting officer's consistent characterization of advance payments

Advance Payments from Prime Contractors to Their Subs (cont'd):

made by a cost-reimbursable contractor to its subcontractors as allowable costs could push the risk of non-performance by those subcontractors onto the Government. While such approvals are not a violation of the plain meaning of the relevant statutes or regulations, it potentially exacerbates precisely what the statutes seek to mitigate.

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Alternatively, the Government could argue that, even if the contracting officer did expressly characterize these advance payments as allowable costs and assumed the ultimate risk of loss, such a commitment was outside of the contracting officer's authority and therefore the Government is not bound by it. The Government could not rely persuasively on *Johnson* because that case involved a fixed-price contract where the Government actually made advance payments to its prime contractor;[25] in the present hypothetical scenario, the Government made no advance payments and the contract in question is cost-reimbursable. Also in *Johnson*, the CAFC determined that the contracting officer could not deem the advance payment repaid when the contractor purchased equipment that was related to contract performance, but whose cost was not to be deducted from the fixed price due the contractor.[26] Such an arrangement essentially converted the advance payment from a loan into a gift; and the CAFC held that the contracting officer was not authorized to bestow gifts onto government contractors.[27] The issue in *Johnson* was not the *allowability* of certain contract costs, but the contracting officer's lack of *authority* to give away Government money.

Additionally, as stated above, where the contractor advances money to its subcontractor with the express approval of the contracting officer, but the Government has not advanced any of its own money, the Government will not be deemed to have made an advance payment. While FAR 31.205-3 should

Advance Payments from Prime Contractors to Their Subs (cont'd):

prevent a contracting officer from authorizing these advance payments without expressly stating that the contractor bears the ultimate risk of loss should a subcontractor fail to perform, case law demonstrates that the contracting officer's deviation from FAR Subpart 31.2 does not constitute an unauthorized commitment.[28] Such a situation is more akin to *Appeal of Lockheed Martin* than it is to *Johnson*, and thus it is likely that the advance payments could be construed as an allowable cost should a subcontractor fail to perform.

VII. Conclusion

This hypothetical situation puts financial risks on the Government where Congress does not want it, but that is just part of the problem. Contracts and business relationships are better managed when the parties are aware of their liabilities at all times. Contractors that ask for a contracting officer's approval of an advance payment are likely to believe that the Government is insuring them against the ultimate risk of loss. On the other hand, a contracting officer granting such an approval may think it simply an administrative act and not even consider the potential consequences. Such miscommunication sows the seeds of litigation.

Endnotes

1. *See* UNITED STATES GENERAL ACCOUNTING OFFICE, PRINCIPLES OF FEDERAL APPROPRIATIONS LAW ("GAO Redbook"), 5-42 (2nd ed., 1991), *quoting* 25 Comp. Gen. 834, 835 (1946).
2. 41 U.S.C. § 255.
3. 10 U.S.C. § 2307.
4. *See* GAO Redbook, *supra* note 1 at 5-46.
5. FAR 32.102 (a) (emphasis added).
6. FAR 32.402 (b).
7. *Id*. at (c).
8. 308 F.3d 1245, 1256 (Fed. Cir. 2002).
9. *See id.* at 1253-57.
10. *Id*. at 1248.
11. *See* ITT Arctic Servs., Inc. v. United States, 207 Ct. Cl. 743 (1975); *see also* Chevron U.S.A., Inc., ASBCA No. 32323, 90-1 BCA ¶ 22,602.
12. *See* FAR 16.301-1.
13. FAR 31.205-3.
14. Appeal of Lockheed Martin Western Development Laboratories, ASBCA No. 51452, 02-1 BCA ¶ 31,803 at 157,102; *citing* Lockheed-Georgia Company, A Division of Lockheed Corporation, ASBCA No. 27660, 90-3 BCA ¶ 22,957 at 115,276; *see also* Rockwell International Corp., ASBCA No. 20304, 76-2 BCA ¶ 12,131 at 58,302.
15. Lockheed Martin, ASBCA No. 51452 at 157,090 – 091. FAR 31.205-35 limits the amount of employee-relocation costs deemed allowable.
16. *Id.* at 157,090.
17. *Id.* at 157,104.
18. *Id.* at 157,104.
19. *See* FAR 32.402(b) (emphasis added).
20. *See* Lockheed Martin, *supra* note 14 at 157,102.
21. *See Id.* at 157,103.

22. *See* FAR 31.109.
23. General Electric Company v. United States, 60 Ct. Cl. 782, 791 (2004).
24. Barron Bancshares, Inc. v. United States, 366 F.3d 1360, 1375 (Fed. Cir. 2004).
25. *See* Johnson, *supra* note 8 at 1256.
26. *Id*.
27. *Id*.
28. *See* Lockheed Martin, *supra* note 15 at 157,103.

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The Pension Protection Act of 2006:
A Primer for Government Contractors and Grantees

by

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For any organization that charges pension costs to its government contracts or grants, there is much work to be done related to the Pension Protection Act of 2006, which is the first major pension legislation in 32 years.

The act makes numerous sweeping changes that will affect virtually all organizations with pension plans (including tax exempt organizations). Details of the changes involving minimum funding requirements lay in the domain of compensation and human resources specialists, and the tax consequences of the act must be addressed by tax advisors.

This article is considerably less technical, and will focus on what a non-specialist working for a government contractor or grantee needs to know to have a general understanding of these changes.

I. Background

In the recent past, some corporations with defined benefit pension plans (particularly steel and airline companies) entered into Chapter 11 bankruptcy proceedings. In order to emerge from bankruptcy, some of these companies put together reorganization plans, including pension plan reorganizations that proposed to lessen the cost of the plans by substantially lowering or even eliminating pension benefits.

Understandably, these initiatives were challenged by pension plan beneficiaries. However, the bankruptcy courts ruled in favor of the companies, finding essentially that there was nothing sacrosanct about pension plan liabilities when compared with the many other liabilities of a bankrupt company. As a consequence, the unfunded pension liabilities of these (and other) plans reverted to the Pension Benefit Guaranty Corporation (PBGC).

In a comparatively short period of time, the deficit of the PBGC for single employer programs skyrocketed, and in FY 2005 it amounted to almost $23 billion dollars. Even worse, a study by the Congressional Budget Office estimated that PBGC's deficit would continually increase to almost $90 billion within ten years.

The PBGC needed massive amounts of funding to address a growing crisis, and Congress saw that something needed to be done to prevent the problem at PBGC from getting worse. The voluminous and comprehensive Pension Protection Act (almost a thousand pages) was that response. At a time when Democrats and Republicans disagreed on just about everything, this was one issue that enjoyed wholehearted bipartisan support (the Senate vote was 93-5).

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<u>The Pension Protection Act of 2006 (cont'd):</u>

The congressional intent was emphatically and repeatedly stated in the legislative history: There would be no taxpayer bailout of the PBGC. The message that the Pension Protection Act conveys to the private sector is unambiguous: If you have a pension plan, YOU are going to pay for it. In addition, by adding recordkeeping, audit and disclosure requirements Congress ensured that everything related to pension plans would be transparent.

II. The Pension Protection Act

In essence, the Pension Protection Act legislatively overruled the decisions of bankruptcy courts that permitted companies to use Chapter 11 proceedings to avoid their pension plan obligations. Now when a company goes into bankruptcy (voluntarily or involuntarily), their pension plan is considered terminated as of the date of the filing.

The fundamental problem that the Pension Protection Act is intended to redress is the failure of employers to adequately fund their pension plans. (The PBGC estimated that the total underfunding of PBGC-insured plans to be $450 billion, $100 billion of which related to financially weak companies.) In addition, the new disclosure requirements will ensure that everything related to the plans henceforth will be known to all participants.

Very briefly stated, some of the more significant requirements of the Pension Protection Act are:

- All plans must be fully funded (i.e., 100%), not 90 percent as under the old law.
- Employees may draw on their retirement funds for emergencies, and may leave their benefits to a spouse, domestic partner or dependent.
- Updated mortality tables must be used for actuarial determinations.
- PBGC pension insurance premiums are significantly increased.
- Various restrictions are imposed on underfunded pension plans, and companies with such plans have seven years to make up the shortfall.
- Seriously underfunded plans must pay additional PBGC contributions.
- "Red Zone" pensions (i.e., the most troubled) are required to establish a rehabilitation plan.
- Funding of executive compensation plans is prohibited if the employee's plan is underfunded.
- Although there are a number of changes to pension plan investments, one of the more important is that employees will be entitled to diversify.
- Employers will be required to provide more pension plan information more frequently to participants and beneficiaries.
- The accounting rules regarding how a pension plan's financial condition is to be determined have been made considerably more stringent.

Of course, there are a large number of other changes, but in the interest of brevity they are more in the realm of specialists.

III. What It All Means

<u>The Pension Protection Act of 2006 (cont'd):</u>

Pension costs are a very significant portion of labor costs, so any government contractor or grantee that charges pension costs to its contracts or grants will need to adjust to the new requirements. The changes caused by these adjustments may be expensive depending on the state of an organization's current compliance program.

Large government contractors--those whose government contract revenues exceeded $5 billion last year—are allowed some delayed implementation under the Act. The Cost Accounting Standards Board (CASB) is to revise the funding requirements of CAS 412 and CAS 413 to be consistent with the new minimum required Employee Retirement Income Security Act (ERISA) contributions, and these revisions are to be known as the Cost Accounting Standards Pension Harmonization Rules. Large government contractors do not have to comply with the new funding requirements until the effective date of the Pension Harmonization Rules or January 1, 2011, whichever occurs sooner.

However, there are no delays for government contractors or grantees for complying with any other aspects of the Pension Protection Act.

The new disclosure requirements relate not only to the pension plan funding, but also to the financial accounting and reporting aspects of pension costs. Some accounting abuses of the recent past, which involved understated liabilities and overstated pension plan valuations, will no longer be possible.

Most importantly, *the new funding and enhanced disclosure requirements are inextricably interrelated with an organization's recordkeeping and financial reporting requirements*. Therefore, appropriate adjustments will need to be made to virtually everyone's compliance programs, and soon as most of the new disclosure rules go into effect in 2007 (some rules are effective in 2008, but other rules applicable to hybrid and cash balance plans may apply retroactively). These multi-disciplinary changes span accounting (i.e., financial reporting and tax), legal, and human resources functions.

Further, the pension plan compliance regime will also include Sarbanes-Oxley reviews of internal controls, tax, and Securities and Exchange Commission (SEC) requirements. Even for organizations that are not SEC registrants, adherence with the requirements of the Pension Protection Act will be an integral part of their annual reporting process.

IV. Conclusion

The Pension Protection Act will affect the compliance programs of all but the smallest government contractors and grantees. The extent of that impact will depend on what changes are required for the funding and operation of their pension plans. In addition, significant changes to an organization's recordkeeping and compliance policies and procedures will likely be required.

Once the changes required are ascertained, modifications to an organization's compliance programs will be necessary to ensure proper recordkeeping and reporting is systemically accomplished. The costs of adherence with the Pension Protection Act will be commensurate with the funding level of an organization's pension plan, i.e., the greater the underfunding the greater the compliance costs will be. Accordingly, in competing for government contracts and grants, organizations that do not fully fund their pension plans will be less cost competitive.

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<u>Endnotes</u>

1. Comments of Senator Enzi (R-WY), p. S8747, August 3, 2006.

[2] "Delta Can End Pilot Pension Plan," by Barbara Ortutay, AP Business Wire, Sept. 5, 2006. The article addresses the bankruptcy court's decision related to Delta Airlines, but refers to the 2004 bankruptcy decision involving United Airlines in which United also successfully eliminated its pension plan, thus transferring the pension liability to the PBGC.

[3] Comments of Senator Kennedy (D-MA), p. S8749, August 3, 2006; Comments of Senator Obama (D-IL), p. S8757, August 3, 2006; Comments of Senator Levin (D-MI), p. S8760, August 3, 2006.

[4] Comments of Senator Baucus (D-MT), p. S8762, August 3, 2006.

[5] Comments of Senator Reed (D-RI), p. S8761, August 3, 2006.

[6] Comments of Senator Kennedy (D-MA), p. S8749, August 3, 2006. Specific reference was made to the unpleasant experiences Congress had had with the savings and loan crisis.

[7] Section 404, amending 29 U.S.C. §§1322 and 1344.

[8] Comments of Senator Reed (D-RI), p. S8761, August 3, 2006

[9] Sections 101, 102, 111 and 112.

[10] Section 1001.

[11] Section 102.

[12] Section 401.

[13] Completion of the Cost Accounting Standards Pension Harmonization Rules is not soon expected. In the absence of these rules, some organizations may experience ERISA/CAS conflicts. Therefore, organizations bidding on CAS-covered contracts that are not "large government contractors" (as that term is defined in the Pension Protection Act) will likely need to enter into advance agreements to address their pension costs. Similarly, organizations already performing CAS-covered contracts will need to negotiate bilateral modifications with the administrative contracting officers either under the Changes clause or other relief-granting provisions.

[14] Section 106. The author wishes to thank Richard Loeb, Esq., for his assistance with regard to the relationship between the Pension Protection Act and the Cost Accounting Standards.