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The Clause

A Quarterly Publication of the Boards of Contract Appeals Bar Association

The President's Column David Nadler

Dear BCABA Members:

I was delighted and honored to be elected to serve as the President of the BCABA for the 2008-09 term. I am following in the footsteps of a distinguished group of past Presidents that have made the BCABA the outstanding organization it is today. Indeed, my first order of business is to pay tribute to our immediate past President, Michael Littlejohn, who completed his very successful term in October 2008. Mike was a persistent advocate for the BCABA, and led the expansion of our membership base in both the public and private sectors of the government contracts community. Under Mike's stewardship, the BCABA created a writing award for young attorneys, enhanced our popular trial practice seminar, provided thoughtful comments on the rules of practice for the new Civilian Board of Contract Appeals, and provided input to Congress on the issue of salaries for BCA judges. Mike also presided over our Annual Program which included several outstanding panels and was very well received by the more than 130 attendees.

Together with the Board of Governors, our goal over the next year is to build on this success and to continue to increase membership and the substantive value we bring to our members. In particular, we
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welcome the involvement of the younger members of the government contracts bar who always bring new ideas and fresh perspective to the practice. We will continue to reach out to our government colleagues and welcome their participation in the BCABA, particularly those that work for agencies that are currently not well represented in the BCABA. Watch for an enhanced website that will be more user-friendly and an even better resource for our members on government contracts law and practice. As President-elect Obama has already signaled that there will be significant new legislation and regulatory changes that impact the government and its contractors, there may well be opportunities for us to weigh in on issues of relevance to our members. Of course, we will again have the content-rich programs that are the hallmark of the BCABA including the Trial Advocacy Program, Colloquium, Executive Policy Forum, and the BCA Judges Reception. With the able support of Pete McDonald (our *Editor for Life*), we plan to issue four issues of our journal, *The Clause*, which brings our members timely and interesting commentary on government contracts topics. My thanks to Pete for bringing together another excellent collection of articles for this edition of *The Clause*.

Our meetings this year will be held at the offices of Dickstein Shapiro LLP, 1825 Eye Street, NW, Washington, DC 20006 on December 17, 2008, March 19, 2009, June 18, 2009, and September 17, 2009. As always, our Annual Meeting will be held in October.

All the best for the holidays!

Best regards,

Dave Nadler
President

**Bored of Contract Appeals
(a.k.a. The Editor's Column)**

by
Peter A. McDonald
C.P.A., Esq.
(A nice guy . . . basically.)

Leading this issue is the *Rothe Development* decision by the CAFC. (Ironically, the 8(a) contractor named in the decision, ICT, was my client.) Dave Nadler and Joe Berger then provide a thoughtful overview of what changes in the government contracts sphere can be expected from the new Obama Administration. Following their article is an excellent analysis of the Supreme Court's *Allison Engine* decision, done by Peter Hutt and Steve Wu. Lastly, there is a commentary on CASB's proposed changes to CAS 412 and 413.

The Clause will reprint, with permission, previously published articles. We are also receptive to original articles that may be of interest to government contracts practitioners. Remember: Don't take all this government contract stuff too seriously. We again received some articles that were just not suitable for publication, such as: "Demi Wants Pete Back!"; "Acquisition Corps a Raging Success!!"; and "CASB Gets Full Staff!!!"

United States Court of Appeals for the Federal Circuit
00-1171

ROTHE DEVELOPMENT CORPORATION,
Plaintiff-Appellant,
v.
UNITED STATES DEPARTMENT OF DEFENSE
and UNITED STATES DEPARTMENT OF THE AIR FORCE,
Defendants-Appellees.

David F. Barton, The Gardner Law Firm, of San Antonio, Texas, argued for plaintiff-appellant. With him on the brief were R. Wes Johnson, and Kevin M. Warburton.

Gregory B. Friel, Attorney, Commercial Litigation Branch, Civil Division, Department of Justice, of Washington, DC, argued for defendants-appellees. With him on the brief was Mark L. Gross, Attorney.

John G. Roberts, Jr., Hogan & Hartson L.L.P., of Washington, DC, for amicus curiae The Associated General Contractors of America, Inc. With him on the brief were David G. Leitch, and H. Christopher Bartolomucci. Of counsel on the brief was Michael E. Kennedy, General Counsel, The Associated Contractors of America, Inc., of Alexandria, Virginia.

John H. Findley, Pacific Legal Foundation, of Sacramento, California, for amicus curiae Pacific Legal Foundation.

Philip Allen Lacovara, Mayer, Brown & Platt, of New York, New York, for amici curiae Asian American Legal Defense and Education Fund, Et. Al. With him on the brief were Norman R. Williams, II, and Andrew H. Schapiro. Of counsel was Carolyn B. Greenwald.

Appealed from: United States District Court for the Western District of Texas

Judge Edward C. Prado

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United States Court of Appeals for the Federal Circuit
00-1171

ROTHE DEVELOPMENT CORPORATION,
Plaintiff-Appellant,
v.
UNITED STATES DEPARTMENT OF DEFENSE
and UNITED STATES DEPARTMENT OF THE AIR FORCE,
Defendants-Appellees.

DECIDED: August 20, 2001

Before MICHEL, CLEVINGER, and GAJARSA, Circuit Judges.

MICHEL, Circuit Judge.

This federal contract case concerns the constitutionality of § 1207 of the National Defense Authorization Act of 1987 (“the 1207 program”), Pub. L. No. 99-661, 100 Stat. 3859, 3973 (1986) (as amended), codified at 10 U.S.C. § 2323 (1994), which permits the United States Department of Defense (“DOD”) to preferentially select bids submitted by small businesses owned by socially and economically disadvantaged individuals (“SDBs”). The 1207 program operates by increasing the bid of a non-minority-owned firm by up to ten percent via a mechanism called a “price-evaluation” adjustment. Rothe Development Corporation (“Rothe”) appeals the April 27, 1999 decision of the United States District Court for the Western District of Texas granting summary judgment in favor of the government that the 1207 program is constitutional, as enacted and as applied in this case in which Rothe lost an Air Force contract to a SDB due to application of the 1207 program. Rothe Dev. Corp. v. United States Dep’t of Defense, 49 F. Supp.2d 937, 953 (W.D. Tex. 1999) (“Rothe I”). In reviewing the program, the district court applied a deferential standard of review, and relied extensively on evidence post-dating the reauthorization of the 1207 program collected in an amicus brief filed on behalf of the government, and in a 1998 government study. Rothe contends that the 1207 program violates its equal protection rights under the Due Process Clause of the Fifth Amendment to the United States Constitution, because the program lacks the evidentiary foundation required to justify the enactment and application of a race-based classification. In defending the program, the government argues that Congress had sufficient evidence from which to conclude that the DOD had at least been a “passive participant” in perpetuating the lingering effects of past, private discriminatory conduct that significantly handicapped minorities from obtaining defense contracts, such that race-based remedial relief was justified, and moreover, that the 1207 program was narrowly tailored in addressing this remedial need. The government also argues that evidence post-dating the program’s last reauthorization in 1992 justified the program even if we find that the pre-reauthorization
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Rothe Development Corp. v. DOD (cont'd):

evidence alone was insufficient. Because we conclude that the district court improperly applied a deferential legal standard rather than “strict scrutiny,” and also impermissibly relied on post-reauthorization evidence to support the program’s constitutionality as reauthorized, we vacate the judgment of the district court and remand for further proceedings consistent with this opinion.

Background

A. The 1207 Program

1. Purpose and History of the 1207 Program

Congress enacted the 1207 program to “ensure that substantial progress is made in increasing awards of [DOD] contracts to section 1207(a) entities.” Pub. L. No. 100-180, §806(a), 101 Stat. 1019, 1126 (1987). First enacted by Congress for fiscal years 1987 through 1989, §1207 sets a “goal” that five percent of the total dollar amount obligated for defense contracts and subcontracts for each fiscal year would be awarded to businesses that 1) are “small”; and 2) are “owned and controlled by” socially and economically disadvantaged individuals. 10 U.S.C. §2323(a)(1)(A). The five percent goal is a department-wide goal that is not segmented by industry categories.¹ H.R. Conf. Rep. No. 101-331 at 614, reprinted in 1989 U.S.C.C.A.N. 977, 1071. The relevant statutory language provides:

- a. Goal.-- (1) Except as provided in subsection (d), a goal of 5 percent of the amount described in subsection (b) shall be the objective of the Department of Defense . . . in each fiscal year for the total combined amount obligated for contracts and subcontracts entered into with –
A. small business concerns . . . owned and controlled by socially and economically disadvantaged individuals (as such term is used in section 8(d) of the Small Business Act (15 U.S.C. §637(d)) and regulations issued under that section) . . .

10 U.S.C. §2323(a)(1)(A). In order to meet the goal, regulations promulgated pursuant to §1207 authorized the DOD to raise the bids of non-SDB bidders by as much as ten percent above the fair market price per contract.² 48 C.F.R. subpart 219.10 (1997); *id.* §§252.219-7000 & -7006.³

The 1207 program was initially enacted as a three-year pilot program. In 1989, Congress extended the program from 1990 until 1993, with the hope that the “additional three years [would] provide the [DOD], and the defense industry, with the opportunity to vigorously pursue the program’s fundamental objective: to expand the participation of disadvantaged small business concerns . . . in the defense marketplace.” H.R. Rep. No. 101-331, at 614, reprinted in 1989 U.S.C.C.A.N. 977, 1071; Pub. L. No. 101-189, § 831(b), 103 Stat. 1352, 1507 (1989). Despite the continuation of the program beyond its initial period of authorization, in the first five years of the program, the DOD did not meet the goal of increasing participation by SDBs to five percent of its total dollar amount allocated for
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Rothe Development Corp. v. DOD (cont'd):

contracts and subcontracts. As a result, in 1992, Congress reauthorized the program for seven more years, through fiscal year 2000. Pub. L. No. 102-484, §801(a)(1)(B), 106 Stat. 2315, 2442 (1992). In every year since the 1992 reauthorization, the DOD has met the five percent goal. In 1997, for instance, the Air Force awarded at least 9.7 percent of its total eligible contract dollars to SDBs.

In 1998, Congress amended the 1207 program to require the DOD to suspend the use of the price-evaluation adjustment for one year after any fiscal year in which the DOD awards more than five percent of its eligible contract dollars to SDBs. Pub. L. No. 105-261, §801, 112 Stat. 1920, 2080-81 (1998). Because the DOD met the five percent goal in both fiscal years 1998 and 1999, the DOD suspended the ten percent preference for those last two calendar years. In 1999, Congress reauthorized the 1207 program for three more years. Pub. L. No. 106-65, § 808, 113 Stat. 512, 705 (1999). Without congressional reauthorization, the 1207 program will expire at the end of fiscal year 2003.

2. Requirements of the 1207 Program

The race-based preference program challenged in this case was established pursuant to §1207, and incorporated portions of the Small Business Act (“Act”), 15 U.S.C. §§637(d) and 644(g) (1994). Section 1207 references §8(d) of the Act, as amended, 15 U.S.C. §631 (1994), *et seq.*, to define a SDB according to the racial or ethnic background of the controlling owner. 10 U.S.C. §2323(a)(1)(A); 15 U.S.C. §637(d). A business is “small” if it is independently owned and operated, if it is not dominant in its field of operation, and if its number of employees or annual gross receipts fall below predetermined levels. 15 U.S.C. §632(a)(1) (1994). The Act defines “socially disadvantaged individuals” as “those who have been subjected to racial or ethnic prejudice or cultural bias because of their identity as a member of a group without regard to their individual qualities.” 15 U.S.C. §637(a)(5). “Economically disadvantaged individuals” are defined as “those socially disadvantaged individuals whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared to others in the same business area who are not socially disadvantaged.” 15 U.S.C. §637(a)(6)(A). Under the Act, five groups (comprising thirty-seven subgroups), including Asian-Pacific Americans, are presumed to be socially and economically disadvantaged.⁴ 15 U.S.C. §637(d)(3)(C). A member of such a group is deemed to own and control a SDB if he or she owns at least fifty-one percent of the business, and controls management and daily operations. 15 U.S.C. §637(d)(3)(C)(i)(ii). Regulations promulgated pursuant to the statute provide that either a contracting officer, an unsuccessful bidder, or the Small Business Administration (“SBA”) may challenge an individual’s presumptive status as socially or economically disadvantaged. 48 C.F.R. §219.302-70 (1997). Bidding SDBs may elect to waive the price-evaluation adjustment. 48 C.F.R. §219.7002(a).

Section 1207 and its implementing regulations impose a number of requirements in order for SDBs to participate in the program. Under regulations promulgated pursuant to the *(continued on next page)*

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statute, an owner of a SDB must have a net personal worth of less than \$750,000, excluding the value of his or her place of business and personal residence. 13 C.F.R. §124.106(b)(2) (1998). Moreover, individuals who are not members of the presumptively disadvantaged groups can nevertheless be entitled to application of the price-evaluation adjustment to bids of competitors provided they demonstrate that they have been socially or economically disadvantaged because of their “color, ethnicity, gender, physical handicap, long-term residence in an environment isolated from the mainstream of American society, or other similar cause not common to small business persons who are not socially disadvantaged.” 13 C.F.R. §124.105(c)(1)(i) (1998).

B. The Contract at Issue

Rothe is based in San Antonio, Texas, and is owned by Ms. Suzanne Patenaude, a Caucasian female. Since 1987, Rothe had contracted with the Department of the Air Force to maintain, operate, and repair the computer systems of the Switchboard Operations and Network Control Center (“NCC”) at Columbus Air Force Base in Mississippi. Korean-Americans David and Kim Sohn of Baltimore, Maryland, own and operate International Computer and Telecommunications, Inc. (“ICT”), a SDB with annual revenues of approximately \$13 million. ICT also performs computer maintenance and repair work and was Rothe’s “number one competitor.”

In an effort to improve contractor accountability and quality, the Air Force decided to consolidate Rothe’s Switchboard/NCC contract with a contract for Base Telecommunications Services (“BTS”). On March 6, 1998, the 38th Engineering Installation Wing at Tinker Air Force Base, Oklahoma, issued a solicitation for competitive bids on the combined contract, and announced that, unlike predecessor contracts, the proposed contract would be let pursuant to the 1207 program. Five contractors submitted bids. Two bidders were SDBs. Rothe, which was not a SDB, bid \$5.57 million, and was the lowest bidder. ICT, which was a SDB and thus could participate in the 1207 program, bid \$5.75 million. Through application of the price-evaluation adjustment, Rothe’s bid was increased to \$6.1 million for purposes of the bid selection. On August 20, 1998, the Air Force awarded the contract to ICT, the “fictionally” lowest bidder. According to the district court, the parties agree that Rothe lost the bid only because of application of the price-evaluation adjustment. *Rothe I*, 49 F. Supp.2d at 941.

The contract in this case was scheduled to expire on September 30, 1999. However, the Air Force exercised an option to extend ICT’s contract through September 30, 2001. ICT has not performed any work under the disputed contract since April 30, 1999, however, because first the United States Court of Appeals for the Fifth Circuit and later this court imposed a stay pending resolution of this appeal. As a consequence, the Air Force issued a new solicitation for the work covered by the disputed contract. Thus, the lawfulness of the award of the contract to ICT is not at issue.

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C. Procedural History

On November 5, 1998, Rothe brought suit against the DOD and the United States Department of the Air Force, challenging the constitutionality of the 1207 program both as enacted and as applied under the equal protection component of the Fifth Amendment's Due Process Clause. Rothe sought declaratory and injunctive relief barring award of the contract and continued application of the 1207 program to future contracts, and monetary damages to compensate it for its bid preparation costs and attorney fees. On November 25, 1998, the United States District Court for the Western District of Texas denied Rothe's motion for a preliminary injunction. On February 26, 1999, the parties filed cross-motions for summary judgment. On April 27, 1999, the district court granted summary judgment in favor of the government and entered its judgment. (Rothe I).

Rothe filed a timely notice of appeal to the United States Court of Appeals for the Fifth Circuit. The government moved to dismiss for lack of subject matter jurisdiction. Rothe Dev. Corp. v. United States Dep't of Defense, 194 F.3d 622 (5th Cir. 1999) ("Rothe II"). On October 27, 1999, the Fifth Circuit granted the government's motion, holding that it lacked jurisdiction over the appeal, but instead of dismissing the appeal, transferred it to this court. *Id.* at 626. We heard oral argument in this case on November 8, 2000.

Analysis

A. Standard of Appellate Review

We review a district court's grant of summary judgment de novo. Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(c); see also Celotex Corp. v. Catrett, 477 U.S. 317, 322-23 (1986); Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247 (1986). In evaluating the grant of a motion for summary judgment, our task is to discern whether "the record taken as a whole could not lead a rational trier of fact to find for the non-moving party." Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986). In this case, however, the issues are ones of law based on underlying facts that are essentially undisputed. What is sharply disputed are the inferences and conclusions that may properly be drawn from those underlying facts.

B. Jurisdiction

Under 28 U.S.C. §1295(a)(2) (1994), this court has exclusive jurisdiction to hear appeals and decide all issues raised in cases in which the district court's subject matter jurisdiction is "based, in whole or in part," on the Tucker Act, 28 U.S.C. §1346(a)(2) (1994) (emphasis added). The Tucker Act confers on district courts original jurisdiction, concurrent with that of the United States Court of Federal Claims, over "[a]ny . . . civil action or claim (*continued on next page*)

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against the United States, not exceeding \$10,000 in amount, founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort.” *Id.* Under the Tucker Act, an unsuccessful bidder can recover its bid preparation costs from the government on the theory that failure to evaluate a “bid honestly and fairly” breaches an implied-in-fact contract of fair dealing. Coflexip & Servs., Inc. v. United States, 961 F.2d 951, 952-53 (Fed. Cir. 1992). As a suit to recover its bid preparation costs, Rothe’s complaint invoked the Tucker Act. Thus, this court has exclusive jurisdiction over all issues Rothe raises in this appeal. Therefore, we will not return the appeal to the Fifth Circuit and will address all issues properly raised.

C. Burden of Proof

As a preliminary matter, we must address whether the district court correctly allocated the burden of proof. Rothe argues that the district court erred in placing the burden on Rothe to prove that the price-evaluation adjustment was unconstitutional. Citing Adarand Constructors, Inc. v. Peña, 515 U.S. 200 (1995) (“Adarand III”), Rothe contends that it is the governmental actor that must justify its use of an affirmative action program. Rothe I, 49 F. Supp.2d at 945.

We believe the district court correctly placed the burden of proof on Rothe to demonstrate that the program was unconstitutional. Before a court can assess whether a plaintiff has met his or her burden of proof, however, the court must review the government’s evidentiary support to determine whether the legislative body had a “strong basis in evidence” to believe that remedial action based on race was necessary. Wygant v. Jackson Bd. of Ed., Inc., 476 U.S. 276, 277 (1986) (plurality op.). Thus, the government bears the burden to produce evidence, i.e., the burden of going forward with evidence. The challengers, however, “continue to bear the ultimate burden of persuading the court that the [entity’s] evidence did not support an inference of prior discrimination and thus a remedial purpose, or that the plan instituted on the basis of this evidence was not sufficiently ‘narrowly tailored.’” *Id.* at 293 (O’Connor, J., concurring).

D. Legal Standard for Reviewing Federal Race-Based Classifications

1. Congress’ Authority to Enact Race-Based Classifications

Congress’ authority to enact race-based classifications flows from either of two distinct sources of congressional power. Under Article I of the United States Constitution, Congress can attach race-based conditions when it appropriates for a federal program. When it enacts legislation pursuant to Article I, it is free to attach any race-based condition so long as it does so without violating the equal protection component of the Fifth Amendment’s Due Process Clause.⁵ See Fullilove v. Klutznick, 448 U.S. 448, 480 (1980).

Additionally, §5 of the Fourteenth Amendment gives Congress a separate and distinct source of authority to enact remedial racial classifications.⁶ Section 5 is a “positive grant of
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legislative power” to Congress, Katzenbach v. Morgan, 384 U.S. 641, 651 (1966), that is limited to congressional remedial action against the state and state actors, not private individuals. See e.g., Bd. of Trustees of the Univ. of Ala. v. Garrett, 121 S.Ct. 955, 964 (2001) (“Congress’ §5 authority is appropriately exercised only in response to state transgressions.”). Nor does it apply against federal actors. The limits placed on Congress when it enacts a program under §5 have not been clearly defined, as the Supreme Court has expressly declined to decide whether deference applies. See Adarand III, 515 U.S. at 230 (noting that justices have taken “different views” on the “extent to which courts should defer to Congress’ exercise of [its §5] authority,” but that the Court declined to address those differences).

The 1207 program was enacted pursuant to Congress’ Article I powers to appropriate funds for the Armed Forces, and is a program that affects private firms that submit bids to contract with the DOD. See Metro Broadcasting Inc. v. FCC, 497 U.S. 547, 605-66 (1990) (O’Connor, J., dissenting) (rejecting the argument that §5 applies to federal programs administered by federal officials). Thus, in determining whether the 1207 program is constitutional, we must review the governing case law to determine the limits the Fifth Amendment places on congressional power to enact racial classifications under Article I. We do not, and need not, decide the proper analysis for cases involving Congress’ power under §5 of the Fourteenth Amendment.

2. The Fifth Amendment as a Limit on Congressional Power to Enact Race-Based Classifications

Prior to 1995, the Supreme Court applied a different standard of review depending upon the constitutional basis for enacting the classification. If the program was enacted by a state or municipality, and thus subject to the limits of §1 of the Fourteenth Amendment, the Court applied the highest level of review -- “strict scrutiny.” City of Richmond v. J.A. Croson Co., 488 U.S. 469, 494 (1989).⁷ Determining whether a racial classification satisfied strict scrutiny required an inquiry into whether the “suspect classification” (i.e., race) served a “compelling interest” and was “narrowly tailored” in furtherance of that interest. Id.

Initially, however, the Supreme Court construed the limits placed on federal programs under the Fifth Amendment (and thus applicable to federal programs enacted under Article I) to be different than those under the Fourteenth Amendment (applicable to states and municipalities). Until 1995, race-based classifications enacted by the federal government were subject to middle-tier scrutiny -- “intermediate scrutiny” -- whereby the classification would satisfy constitutional requirements if it was “substantially related” to an “important” governmental objective. Metro Broadcasting, 497 U.S. at 565-66.⁸

In 1995, in Adarand III,⁹ a case involving the constitutionality of a federal racial classification enacted under Article I, a 5-4 majority of the Court definitively held that all racial classifications -- whether they be enacted by a state, a municipality, or the federal government

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Rothe Development Corp. v. DOD (cont'd):

-- are subject to the strictest judicial scrutiny.¹⁰ Adarand III, 515 U.S. at 224 (holding that “any person, of whatever race, has the right to demand that any governmental actor subject to the Constitution justify any racial classification subjecting that person to unequal treatment under the strictest judicial scrutiny”) (emphasis added). While the Adarand III Court did not detail the precise analysis to apply to a federal racial classification,¹¹ the Court’s express abandonment of prior case law applying different and less rigorous levels of scrutiny to federal racial classifications left no doubt that the Court intended there to be only one kind of strict scrutiny, applied with the same level of rigor to both state/municipal racial classifications and federal racial classifications enacted under Congress’ Article I power. Id. at 225 (abandoning the Metro Broadcasting approach because such approach had “repudiated the long-held notion that ‘it would be unthinkable that the same Constitution would impose a lesser duty on the Federal Government’ than it does on a State to afford equal protection of the laws”) (internal citation omitted) (emphasis added); id. at 235 (noting that the Fullilove approach applying intermediate scrutiny to federal racial classifications was “no longer controlling” to the extent it would hold federal racial classifications “to a less rigorous standard”)¹² (emphasis added).

Moreover, the Court’s reference to its historical practice of applying Fourteenth Amendment precedent to Fifth Amendment equal protection problems provides a clear indication that it is the Croson analysis -- applied earlier to state and municipal classifications -- that provides the benchmark for judging the constitutionality of a federal racial classification. Id. at 217 (noting that “[i]n case after case, [F]ifth [A]mendment equal protection problems are discussed on the assumption that [F]ourteenth [A]mendment precedents are controlling”) (citing Karst, The Fifth Amendment’s Guarantee of Equal Protection, 55 N.C. L. Rev. 541, 554 (1977)); see also id. at 223 (noting that even after Metro Broadcasting, the Court “indicated that Croson had at least some bearing on federal race-based action when it vacated a decision upholding such action and remanded for further consideration in light of Croson”) (citing H.K. Porter Co. v. Metro. Dade County, 489 U.S. 1062 (1989)); id. (citing Mann v. Albany, 883 F.2d 999, 1006 (11th Cir. 1989) (“Croson ‘may be applicable to race-based classifications imposed by Congress.’”)).

E. Analysis of the Legal Standard Applied by the District Court

Although acknowledging that strict scrutiny must be applied in reviewing a federal racial classification, the district court in this case opined that Congress, unlike states or municipalities, should be given deference both “in articulating a compelling purpose . . . [and in showing] that its action is narrowly tailored to that purpose.” Rothe I, 49 F. Supp.2d at 949; see also id. (noting that “[i]f Congress is to be allowed a broad vision of the nation’s problems, it seems only logical that it be allowed some measure of deference in addressing those problems”); id. at 950 (noting that “deference should be given to congressional findings that discrimination has continued and must be addressed”). In applying this deferential scrutiny, the district court expressly declined to conduct a Croson-like analysis of the 1207 program. Id. at 949 (stating that federal racial classifications should not be “rigidly held to the

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standards set forth in Croson"); see also id. (noting that the narrow tailoring factors discussed in Croson should not be "applied in lockstep conformity with Croson"); id. at 953 (arguing that "Croson's mandate that a local government make specific findings regarding specific minorities in specific industries" should not be applied "without alteration, to the acts of Congress") (emphasis in original).

The district court supported its approach by relying exclusively on language in two Supreme Court plurality opinions, both discussing Congress' remedial powers under §5 of the Fourteenth Amendment, not the limits imposed by the Fifth Amendment on the exercise of its Article I appropriating powers. Id. at 943-44. The district court noted that in both the Fullilove and Croson plurality opinions, certain members of the Court had indicated that since Congress enjoyed a "more comprehensive remedial power" than other governmental bodies with which to enforce equal protection guarantees, its findings would be entitled to greater deference than those of a state or municipal legislative body.¹³ Id. at 943 (citing Fullilove, 448 U.S. at 483); see also id. at 944 (noting that in Croson, Justice O'Connor, when writing for only a plurality, had allegedly "affirmed the Court's deference to federal programs," when she observed that "Congress, unlike any State or political subdivision, has a specific constitutional mandate to enforce the dictates of the Fourteenth Amendment") (citing Croson, 488 U.S. at 490 (plurality op., O'Connor, J.)). Adarand III, the district court said, had left undisturbed the various justices' previously expressed views on Congress' remedial power. The district court noted that in Adarand III, "Justice O'Connor, again writing for only a plurality of the Court, merely acknowledged that the Court as a whole had not yet come to terms with the question of what deference to give congressional remedial actions." Id. The district court thus opined that since "no justice on the Court" had "repudiated . . . his or her previously expressed views on the subject," id. at 944 (citing Adarand III, 515 U.S. at 231), "a simple headcount assures this court that a majority of the Supreme Court, including Justice O'Connor and the four dissenters in Adarand, would favor some standard that allowed Congress a broader brush than it would allow the states with which to design remedial measures for the purpose of addressing nationwide discrimination." Id. In fashioning this broader brush, the district court concluded that it need not scrutinize as rigorously Congress' conclusion that remedial action was necessary and that it was narrowly tailored. Id. at 946.

We hold that the district court erred in concluding that federal racial classifications should be reviewed under a deferential analysis that is not applicable to state or municipal classifications. Indeed, as Justice O'Connor noted in Adarand III, creating a distinction between state and federal racial classifications "lacks support" in Supreme Court precedent and "undermines the fundamental principle of equal protection as a personal right." Adarand III, 515 U.S. at 235 (plurality op., O'Connor, J.). In effect, the district court appears to have discerned in the plurality and dissenting opinions a basis to apply to federal programs a watered-down version of strict scrutiny as articulated in Croson. We reject the notion of lesser scrutiny, which seems suspiciously like the middle-tier scrutiny of Metro Broadcasting. While the district court may be correct that Congress may be owed deference when it legislates pursuant to §5, that issue is not before us today. The 1207 program was enacted pursuant to
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Article I, and so, as set forth in Adarand III, Congress is entitled to no deference in determining whether Congress had a compelling interest in enacting the racial classification, and that the classification was narrowly tailored in fulfillment of that interest.¹⁴ On remand, thus, the District court should undertake the same type of detailed, skeptical, non-deferential analysis undertaken by the Croson Court, but specifically account for the factual differences between this program and that at issue in Croson. Id. at 228 (noting that strict scrutiny requires taking “relevant differences into account”). Adopting the strict scrutiny analysis to the specific facts at issue in a case, however, must not result in a lesser degree of scrutiny than was required by the Court in Croson. Strict scrutiny is a single standard and must be followed here.

F. Pre-Reauthorization Evidence

The district court admittedly engaged in only a cursory analysis of the evidence before Congress at the time of the reauthorization of the 1207 program, choosing instead to focus primarily on post-reauthorization evidence. Because the reauthorization of the 1207 program in 1992 constitutes a new statute, the district court need only have considered whether there was a compelling interest in reauthorizing the 1207 program in 1992; it is irrelevant for purposes of this case whether the original statute fails for want of a sufficient factual predicate.¹⁵ As to the pre-reauthorization evidence, the district court merely set forth a list of reports and other materials that Congress apparently had before it during the initial enactment and last reauthorization of the 1207 program. To support its conclusion that Congress had a compelling interest in enacting the 1207 program, the district court cited three congressional documents. Rothe I, 49 F. Supp.2d at 946 (citing 131 Cong. Rec. 17,445 (1985); 131 Cong. Rec. 21,714 (1986); Small Disadvantaged Business Preauthorization, Hearing Before the Investigative Subcommittee of the House Committee on Armed Services, 102d Cong., 2d Sess. 53 (1992)). The district court also cited four congressional documents relating to enactment of a separate minority advantage program, the § 8(a) program.¹⁶ Id. (citing H.R. Rep. No. 468, 94th Cong., 1st Sess. 2 (1975) (only three percent of American businesses were owned by minorities, while minorities made up sixteen percent of the population); Congressional Research Service, *Minority Enterprise and Public Policy*, 52-53 (June 9, 19[7]7) (SBA’s success in aiding disadvantaged firms described as “minimal”); *Small and Minority Business in the Decade of the 1980s*, 97th Cong., 1st Sess. 10, 33-34, 220 (1981); and H.R. Rep. No. 460, 100th Cong., 1st Sess. 18 (1987)). To support its conclusion that Asian-Pacific Americans had been discriminated against, the district court referenced findings by the Small Business Administration (“SBA”), made prior to Congress’ inclusion of Asian-Pacific Americans in the SBA’s presumption in 1980. Rothe I, 49 F. Supp.2d at 946; see also Pub. L. No. 95-507, §201, 92 Stat. 1757 (1978); Pub. L. No. 96-302, §118(a), 94 Stat. 833 (1980), codified at 15 U.S.C. § 631(f)(1) (1994).

Under Croson, in order to determine whether a racial classification is constitutional, a reviewing court must be satisfied that a “strong basis in evidence” supports the legislature’s conclusion that discrimination persisted and remedial action was needed. Croson, 488 U.S. at 500 (citing Wygant, 476 U.S. at 277). In order for us to undertake meaningful appellate (continued on next page)

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review, it is essential that the district court set forth detailed findings as to the scope and content of the reports before Congress when it enacted the challenged legislation, and set forth whatever inferences may be drawn as to whether such reports could constitute a “strong basis in evidence” for remedial action. *Id.* at 510 (plurality op., O’Connor, J.) (noting that the reviewing court should make “proper findings” which define both the “scope of the injury and the extent of the remedy necessary to cure its effects”). It is true that the same reports before the district court are before us on appeal, and that whether those reports constitute a “strong basis in evidence” to support the challenged program is a question of law that we will ultimately review *de novo*. However, like the Supreme Court, we believe that it is the province of the district court to evaluate whether evidence within the particular reports and studies before Congress was indeed sufficient to constitute a “strong basis in evidence” of discrimination or its lingering effects. *See Adarand III*, 515 U.S. at 237 (remanding to lower court when lower court improperly applied a lessened level of scrutiny in its analysis of the evidentiary record).

In the present appeal, the mere listing of pre-reauthorization references by the district court fails, we hold, to provide adequate findings on which to conclude that Congress had a “strong basis in evidence” for reauthorizing the 1207 program. Under *Croson*, a race-based classification may be enacted to remedy only identified systematic discrimination. Accordingly, generalized assertions of legislative purpose or statements generally alleging societal discrimination or an individual’s anecdotal accounts of discriminatory conduct would have little or no probative value in supporting enactment of a race-conscious measure. *See Croson*, 488 U.S. at 498 (“[A] generalized assertion that there has been past discrimination in an entire industry provides no guidance for a legislative body to determine the precise scope of the injury it seeks to remedy.”); *Wygant*, 476 U.S. at 276 (“Societal discrimination, without more, is too amorphous a basis for imposing a racially classified remedy.”). The pre-reauthorization evidence cited by the district court does not show that the 1207 program was designed to address a remedial need, nor does it provide any indication that the 1207 program was enacted in response to systematic discrimination against Asian-Pacific Americans or the lingering effects thereof. Moreover, while the SBA’s findings support a conclusion that Congress believed there was sufficient evidence upon which to include Asian-Pacific Americans in the SBA presumption, such a conclusion, made in 1980, seven years before the initial enactment of the 1207 program and almost twelve years before the time of the reenactment, does not necessarily support a conclusion that Congress had a “strong basis in evidence” for including (and, after 1992, for continuing to include) the presumption in the DOD program.

Statistical evidence is particularly important to justify race-based legislation. *See Croson*, 488 U.S. at 509 (plurality op., O’Connor, J.) (noting that a *prima facie* case of discrimination can arise “[w]here there is a significant statistical disparity between the number of qualified minority contractors willing and able to perform a particular service and the number of such contractors actually engaged by the locality or the locality’s prime

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contractors”). Indeed, nearly every court of appeals upholding the constitutionality of a race-based classification has relied in whole or in part on statistical evidence. See, e.g., Cone Corp. v. Hillsborough County, 908 F.2d 908, 915 (11th Cir. 1990) (statistical disparity between “the total percentage of minorities involved in construction and the work going to minorities” shows that “the racial classification in the County plan [was] necessary”); Adarand VII, 228 F.3d at 1173 (disparity between minority availability and market utilization in the highway construction subcontracting industry raises an inference that discriminatory factors have created the disparity). The only pre-reauthorization statistical evidence cited by the district court is a statement in a 1975 House report that “only three percent of American businesses were owned by minorities, while minorities made up sixteen percent of [the] population.” H.R. Rep. No. 468, 94th Cong., 1st Sess. 2 (1975), cited in Rothe I, 49 F. Supp. 2d at 946. We conclude that this statistic itself is insufficient to support the constitutionality of the 1207 program as reauthorized. This report provides no data on how many minorities sought to own small businesses, nor does it take into account the particular industry of the contract at issue, let alone how many minority-owned small businesses in this industry were qualified, willing, and able to compete for DOD contracts, like the one at issue here. Further, the statistic does not take into account the fact that the sheer number of businesses owned by minorities may not be significantly correlated with the volume of business conducted by minority-owned businesses. Moreover, the statistic may be outdated, as it was already twelve years old at the time Congress initially enacted the 1207 program, and seventeen years old at the time of reauthorization.

There may be other evidence in the reports cited by the district court that could suffice to uphold the constitutionality of the 1207 program. However, we believe that it is the province of the district court to make express findings as to whether other evidence that was before Congress at the time of the reauthorization of the 1207 program is sufficient to support its constitutionality. We thus conclude that the pre-reauthorization evidence (at least insofar as it is relied on by the district court) is insufficient to satisfy the “strong basis in evidence” requirement in Croson for determining that there was a compelling interest for reauthorization of the 1207 program.¹⁷

G. Post-Enactment Evidence

The district court relied heavily on two sources of post-enactment evidence in upholding the constitutionality of the 1207 program. First, the court relied on the post-enactment evidence cited in the brief of its amicus curiae, the Asian American Legal Defense and Education Fund (“AALDEF”), to “bolster” its conclusion that Asian-Pacific Americans had been discriminated against. Rothe I, 49 F. Supp.2d at 946 (“Congress has made findings specific to Asian Americans . . . and post-enactment evidence bolsters those findings.”). In a footnote, the district court said that it relied on the brief and “evidence” cited by the AALDEF in “reaching [its] determination that Congress ha[d] a compelling purpose to act to remedy discrimination in government contracting.” Id. at 947 n.8.¹⁸ Second, the court relied on a 1998 “Benchmark Study” conducted by the Department of Commerce. Id. at 947-48. The
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study, based on data collected from a random sample of federal procurements in fiscal year 1996, concluded that although SDBs in the “business services” industry had the capacity to perform 40.2 percent of the federal (civilian and military) contracting dollars, they were awarded only 26.4 percent of those dollars. *Id.* at 947 (citing 63 Fed. Reg. 35,714 (1998)).

The circuit courts seem to be in substantial agreement that there are at least several permissible uses for post-enactment evidence. Evidence gathered after the initial enactment of a racial classification but before the reauthorization or reenactment of the program may certainly be considered to determine whether the program is constitutional as reenacted. *See Concrete Works of Colo., Inc. v. Denver*, 36 F.3d 1513, 1521 (10th Cir. 1994) (noting that post-enactment evidence may be considered when the legislative body modified and expanded the scope of a racial classification since the initial enactment). Moreover, post-enactment evidence may certainly be considered in determining whether a racial classification is constitutional as applied. It is for this reason that some circuit courts have considered post-enactment evidence in determining whether to issue injunctive relief, or in determining whether a race-based program is still narrowly tailored. *See Contractors Ass’n of E. Penn., Inc. v. City of Phila.*, 6 F.3d 990, 1004 (3d Cir. 1993) (“Contractors Ass’n I”) (“Consideration of post-enactment evidence is especially appropriate . . . where the principal relief sought . . . was an injunction.”); *Concrete Works*, 36 F.3d at 1521 (holding that “post-enactment evidence, if carefully scrutinized for its accuracy, will often prove quite useful in evaluating the remedial effects or shortcomings of the race-conscious program”).

The use of post-enactment evidence to justify the constitutionality of a program, as enacted, presents a more difficult question. The Supreme Court has consistently held that once an affirmative action program is challenged in litigation, the program can only be upheld if there is a “strong basis in evidence” that it is remedial in nature. *Wygant*, 276 U.S. at 277; *Crosun*, 488 U.S. at 500. Whether a legislature similarly must have a “strong basis in evidence” of discrimination at the time it first enacts a racial classification, or whether it may satisfy the “strong basis in evidence” standard in litigation by relying on additional post-enactment evidence is a question of which the circuit courts have expressed different views.

It is clear from the Supreme Court opinions that a legislative body must have some evidence of discrimination before it in order to constitutionally enact a race-based program. *See id.* at 509 (plurality op.) (“If the city of Richmond had evidence before it that nonminority contractors were systematically excluding minority businesses from subcontracting opportunities it could take action to end the discriminatory exclusion.”) (emphasis added); *Wygant*, 476 U.S. at 277 (“[A] public employer like the Board must ensure that, before it embarks on an affirmative-action program, it has convincing evidence that remedial action is warranted.”) (emphasis added). Circuit courts have consistently held that, absent a showing that a legislature had some evidence of discrimination before it when it enacted a racial classification, the program would be unconstitutional. *See, e.g., Coral Constr. Co. v. King County*, 941 F.2d 910, 920 (9th Cir. 1991) (“[A]ny program adopted without some legitimate evidence of discrimination is presumptively invalid.”).

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While there is no question that a legislature must have some evidence of discrimination before it may constitutionally enact an affirmative action program, there has been arguable ambiguity as to whether legislatures may only act upon the same “strong basis in evidence” standard that ultimately must be demonstrated during litigation. Statements in Croson and Wygant arguably can be interpreted to suggest that the evidentiary burden faced by a legislature when it enacts a program is substantially less than when such a program is ultimately challenged in court. For example, in Croson, the Court noted that “[w]hile the States and their subdivisions may take remedial action when they possess evidence that their own spending practices are exacerbating a pattern of prior discrimination, they must identify that discrimination . . . with some specificity before they may use race-conscious relief.” Croson, 488 U.S. at 504 (emphasis added). Similarly, Justice Powell’s plurality opinion in Wygant states that “the Court has insisted upon some showing of prior discrimination by the governmental unit involved before allowing limited use of racial classifications in order to remedy such discrimination.” Wygant, 476 U.S. at 274 (emphasis added). Some circuit courts have read these statements and others to support a holding that the evidentiary requirement imposed on legislatures is significantly lower than the “strong basis in evidence” requirement imposed when the program is challenged in litigation. See, e.g., Coral Constr., 941 F.2d at 921 (“[W]here a state has a good faith reason to believe that systematic discrimination has occurred, and is continuing to occur, in a local industry, we will not strike down the program for inadequacy of the record if subsequent factfinding bears out the need for the program.”); Ensley Branch N.A.A.C.P. v. Seibels, 31 F.3d 1548, 1568 (11th Cir. 1994) (“It is not necessary . . . for the City and Board to show that, when they approved the decrees, they already had strong evidence of . . . discrimination.”); Contractors Ass’n of E. Penn., Inc. v. City of Phila., 91 F.3d 586, 591 n.21 (3d Cir. 1996) (“Contractors Ass’n II”) (noting that “it is appropriate to consider any evidence, pre- or post-enactment, relevant to the issue of whether such discrimination, or the effects thereof, existed prior to 1982 [the date the challenged ordinance was first enacted]”).

More recent Supreme Court cases clarify, however, that there is no difference in the evidentiary burden that must be faced during litigation (i.e., a “strong basis in evidence”) and the evidence that a legislature must have before it when it enacts a racial classification. In Shaw v. Hunt, 517 U.S. 899 (1996), the Court considered whether the State of North Carolina’s congressional redistricting plan contained impermissible racial gerrymandering.¹⁹ Id. at 909. In setting forth the standard governing whether the gerrymandering could be interpreted as necessary to avoid liability under the Voting Rights Act, 42 U.S.C. §1973 (1994), the Court made clear that the state legislature would be required to have a “strong basis in evidence” that the gerrymandering was a necessary remedy prior to enacting the plan. Id. at 908. “[T]he institution that makes the racial distinction must have had a ‘strong

basis in evidence’ to conclude that remedial action was necessary, ‘before it embarks on an affirmative-action program.’” Id. at 910 (quoting Wygant, 476 U.S. at 277) (emphasis in original). Importantly, the Court italicized the word “before,” emphasizing that the legislature had to have the evidence at the time of its enactment. Moreover, alleviating any ambiguity as
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to the scope of the required evidence, the Court made clear that the legislature had to have a “strong basis in evidence.” This, of course, is the same phrase that the Supreme Court used in both Wygant and Croson to describe the amount of evidence that must ultimately be shown during litigation to uphold the constitutionality of the program. The Shaw Court also emphasized that the reviewing court must assess what “actually” motivated the legislature, not what “may have motivated it.” Id. at 908 n.4 (“[A] racial classification cannot withstand strict scrutiny based upon speculation about what ‘may have motivated’ the legislature. To be a compelling interest, the State must show that the alleged objective was the legislature’s ‘actual purpose’ for the discriminatory classification.”). A plurality of justices in Croson reasoned, “the purpose of strict scrutiny is to ‘smoke out’ illegitimate uses of race by assuring that the legislative body is pursuing a goal important enough to warrant use of a highly suspect tool.” Croson, 488 U.S. at 494 (plurality op., O’Connor, J.). Construing federal law, a majority of justices in Adarand III adhered to the Croson plurality’s recognition that governmental motivation plays a prominent role in a strict scrutiny analysis of a federal race-based scheme. Adarand III, 515 U.S. at 226 (quoting the above-referenced language in Croson and subsequently stating: “We adhere to that view today.”). It is axiomatic that a court cannot “smoke out” illegitimate uses of race in governmental pronouncements with evidence not available to the governmental body prior to promulgation.

Moreover, in Bush v. Vera, 517 U.S. 952 (1996), an opinion issued the same day as Shaw in which the court said that the results of the 1992 election could not be used to support a redistricting plan approved in 1991, Justice O’Connor, writing for a plurality, again quoted the “strong basis in evidence” test from Shaw and emphasized the word “before.” Bush, 517 U.S. at 982 (noting that the legislature “must have had a ‘strong basis in evidence’ to conclude that remedial action was necessary, ‘before it embarks on an affirmative action program,’” quoting Shaw, 517 U.S. at 910) (emphasis in original).

Thus, Shaw makes clear that the quantum of evidence that is ultimately necessary to uphold racial classifications must have actually been before the legislature at the time of enactment. In light of Shaw, we conclude that if the pre-reauthorization evidence is insufficient to maintain the program when the program is challenged as reauthorized, the program must be invalidated, regardless of the extent of post-reauthorization evidence. When a program that has been reauthorized is challenged, all evidence available to the appropriate legislative body prior to reauthorization must be considered in assessing the program’s constitutionality. Requiring a “strong basis in evidence” before the legislature enacts or reauthorizes a racial classification is essential for verifying that a program is truly “remedial” in design. See Croson, 488 U.S. at 493 (plurality op., O’Connor, J.). Moreover, our holding finds support in the language of a decision of the Sixth Circuit (and of several district courts).²⁰

Having identified what we believe to be the permissible uses of post-enactment evidence, we now turn to the district court’s opinion. The district court explicitly stated that in reviewing whether Congress had established a compelling interest for enacting a racial classification, it relied on the post-enactment evidence presented by the AALDEF.²¹ Rothe I, (continued on next page)

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49 F. Supp.2d at 946 n.8. The district court also relied on the Benchmark Study to support the government's claim of a compelling interest, *id.* at 947, and to show that the 1207 program's stated numerical goal of five percent minority participation was proportional to the relevant market when the 1207 program was reauthorized in 1992. *Id.* at 952.

We hold that the district court impermissibly used post-enactment evidence to justify its conclusion that Congress acted with a compelling interest when it reauthorized the 1207 program in 1987 and 1992. On remand, the district court must reevaluate the constitutional sufficiency of the 1207 program as reauthorized by reliance only on the pre-reauthorization evidence. The district court, of course, may rely on post-enactment evidence for other purposes. Post-enactment evidence would be particularly relevant in determining whether the 1207 program was constitutional as applied (i.e., whether or not there still exists a compelling need for the program and whether the program is still narrowly tailored).

H. Factors for the District Court to Consider on Remand

We remand for a determination of the constitutionality of the 1207 program under a strict scrutiny standard, particularly in accordance with the principles set forth in Croson and Adarand III. As set forth above, Congress' decision to enact race-based legislation must be

reviewed under the same, non-deferential analysis that applies to state or municipal racial classifications. The constitutionality of the 1207 program must be assessed as reauthorized in 1992, as applied to Rothe's bid in 1998, and at present, to the extent that declaratory or injunctive relief is still sought. Following are general principles to be considered on remand.

1. Compelling Interest

Croson provides that race-based classifications are "strictly reserved for remedial settings." Croson, 488 U.S. at 493 (plurality op., O'Connor, J.). Accordingly, the 1207 program cannot be constitutional unless it was indeed enacted as a remedial measure. In order to ensure that the motive for the 1207 program was legitimate (and not merely the product of "illegitimate racial prejudice or stereotype" or enacted in response to non-racial factors hindering minority participation), the district court must "define both the scope of the injury and the extent of the remedy necessary to cure its effects." *Id.* at 510. If the court determines that the 1207 program is remedial in nature, it should specify whether it is a remedy to correct present discrimination, or only to counter lingering effects of past discrimination. If the case is best characterized as a lingering effects case, the district court would need to make an assessment as to whether the evidence is still probative, i.e., whether the effects of past discrimination have attenuated over time, or if in determining the constitutionality of the 1207 program as applied, whether the lingering effects are still present or were present in 1998 when the 1207 program was applied to Rothe's and ICT's bids. Moreover, the district court should also specify whether the government's involvement in the discrimination or lingering effects is so pervasive such that the government (and in particular, the DOD) became a "passive participant" in perpetuating it. *See id.* at 492 ("[I]f the city could
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show that it had essentially become a ‘passive participant’ in a system of racial exclusion practiced by elements of the local construction industry . . . the city could take affirmative steps to dismantle such a system.”).

The district court properly determined that there are important differences between the 1207 program and the program at issue in Croson, particularly as to geographic scope. As noted above, these factual differences do not influence the standard of review, which is necessarily strict scrutiny. However, for purposes of determining whether Congress had a “strong basis in evidence” for enacting the 1207 program, and whether the program is narrowly tailored, the district court is certainly correct that Congress had a “broader brush” than municipalities for remedying discrimination. Rothe I, 49 F. Supp.2d at 944. Whereas municipalities must necessarily identify discrimination in the immediate locality to justify a race-based program, we do not think that Congress needs to have had evidence before it of discrimination in all fifty states in order to justify the 1207 program. See Adarand VII, 228 F.3d at 1165 (“The fact that Congress’s enactments must serve a compelling interest does not necessitate the conclusion that the scope of that interest must be as geographically limited as that of a local government.”). Contrarily, evidence of a few isolated instances of discrimination would be insufficient to uphold the nationwide program. Where to draw the line is in the first instance a task for the district court.

Furthermore, the district court should determine whether evidence of discrimination is sufficiently pervasive across racial lines to justify granting a preference to all five purportedly disadvantaged racial groups included under the 1207 program. As noted by the Croson Court, Congress may not justify a racial preference that benefits all minorities merely by identifying discrimination as to one racial group. In finding the racial preference in Croson “grossly overinclusive,” the Supreme Court noted that the Richmond City Council had only identified instances of discrimination against blacks, with “absolutely no evidence of past discrimination against Spanish-speaking, Oriental, Indian, Eskimo, or Aleut persons in any aspect of the Richmond construction industry.” Croson, 488 U.S. at 506. A racial preference cannot be “remedial” when a disadvantaged minority member must share his or her remedial relief with other minorities that have never been the victim of discrimination. Id. Accordingly, Congress must have identified a pattern of discrimination that broadly affected all the minorities who receive a preference under the 1207 program. This is not to say that there must have been particular findings (either express or implied) as to each racial subclass in order to justify the program. Rather than identify instances of discrimination against each particular Asian subgroup (i.e., Korean-Americans, Chinese-Americans), the district court might properly determine that Congress had before it evidence of discrimination against Asian-Pacific Americans in general. Adarand VII, 228 F.3d at 1176 n.18 (rejecting contention that “Congress must make specific findings regarding discrimination against every single sub-category of individuals within the broad racial and ethnic categories designated . . .”).

In addition to reviewing whether there was evidence of discrimination (or the lingering effects thereof) against each minority group included in the 1207 program, the district court
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must also determine whether discriminatory conduct or effects were experienced in the specific industry. A reviewing court must not “blindly” defer to the government’s definition of the affected industry. See Croson, 488 U.S. at 501 (“The history of racial classifications in this country suggests that blind judicial deference to legislative or executive pronouncements of necessity has no place in equal protection analysis.”). In this case, the government argues that the industry grouping “business services” in all federal procurement as defined by the Benchmark Study is the appropriate industry; Rothe, in contrast, argues that the industry grouping should be limited to computer maintenance and repair services in the defense industry. We decline to define the relevant industry, because we think that it is incumbent for the district court to review the evidence on which it relied and make findings as to (1) what the relevant industry is; and (2) whether there was sufficient evidence of discrimination in which to justify application of a racial preference in that industry, both in 1992, in 1998, and at the present time (to the extent Rothe still seeks injunctive relief).

Furthermore, the district court should determine whether the evidence before it is sufficiently timely and sufficiently substantive (i.e., not merely anecdotal) to properly support the program’s constitutionality. We note that much of the evidence referenced by the district court was more than a decade old by the time of the 1207 program’s reauthorization in 1992. Whether this evidence remained viable in 1992 when the program was reauthorized, in 1998 when the program was applied to Rothe’s bid, or in 2001, when a ruling on the requested injunctive relief may issue) is a factual question for the district court to resolve.

2. Narrow Tailoring

On remand, the district court must also reassess whether the 1207 program is narrowly tailored, both as reauthorized and as applied, under a non-deferential version of strict scrutiny. There are six factors commonly considered in the narrow tailoring analysis: (1) the necessity of relief; (2) the efficacy of alternative, race-neutral remedies; (3) the flexibility of relief, including the availability of waiver provisions; (4) the relationship of the stated numerical goals to the relevant labor market; (5) the impact of relief on the rights of third parties; and (6) the overinclusiveness or underinclusiveness of the racial classification. United States v. Paradise, 480 U.S. 149, 171 (1987); Croson, 488 U.S. at 506 (including over- and underinclusiveness in the narrow tailoring factors); Adarand III, 515 U.S. at 238-39 (noting that the lower court on remand should consider whether the legislative body had tried race-neutral alternatives and whether the program was limited in duration). In this case, the district court thoroughly analyzed and correctly concluded that the 1207 program was flexible in application, limited in duration, and that it did not unduly impact on the rights of third parties. Rothe I, 49 F.Supp.2d at 951-53. The district court, however, did not properly analyze three of the other narrow tailoring factors.

a. Examining the Efficacy of Race-Neutral Alternatives.

In this case, the district court considered whether Congress had attempted race neutral measures before enacting the 1207 program. Because it applied a deferential analysis, however, (continued on next page)

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it did not strictly scrutinize whether Congress found these race-neutral alternatives ineffective. Id. at 950 (noting that “deference should be given to congressional findings that discrimination has continued and must be addressed, as evidenced by the

repeated renewal of the preference program at issue in this case”). On remand, the district court should conduct a probing analysis of the efficacy of race-neutral alternatives, for instance, by inquiring into any attempts at the application or success of race-neutral alternatives prior to the reauthorization of the 1207 program. The Supreme Court has also suggested that the legislative body make findings that pre-existing antidiscrimination provisions have been enforced but unsuccessfully. See Croson, 488 U.S. at 502 n.3 (“The complete silence of the record concerning enforcement of the city’s own antidiscrimination ordinance flies in the face of the dissent’s vision of a ‘tight-knit industry’ which has prevented blacks from obtaining the experience necessary to participate in construction contracting.”).

b. Evidence Detailing the Relationship Between the Stated Numerical Goal of Five Percent and the Relevant Market

The district court relied exclusively on the Benchmark Study in assessing whether the five percent goal was proportionate to the number of qualified, willing, and able SDBs in the relevant industry group. Rothe I, 49 F. Supp.2d at 952. Because the Benchmark Study was conducted after the 1992 reauthorization, it is not relevant to determining, whether, at the time of the program’s reauthorization, a relationship was shown between the stated numerical goal of five percent minority participation and the relevant industry. Thus, on remand, the district court must determine whether there is any pre-reauthorization evidence linking the numerical goal with the appropriate pool. The district court, of course, may rely on post-enactment evidence, such as the Benchmark Study (provided the court determines the statistical comparison is appropriate) to determine whether in 1998, the five percent goal was still proportionate to the pool of qualified, willing, and able bidders, or whether to grant injunctive relief to the extent Rothe still requests it

c. Over- and Under- Inclusiveness

The district court here deferred to Congress’ conclusion that the 1207 program was not overinclusive. Id. at 953 (“Obviously, Congress must have a basis for acting to remedy discrimination, and obviously, its acts must be aimed at that discrimination.”); id. (finding sufficient the finding that since all of the minorities included in the 1207 program live in the United States and have been discriminated against, the program is not overinclusive.). On remand, the district court must strictly scrutinize whether the 1207 program was overinclusive, by determining whether each of the five minority groups presumptively included in the 1207 program suffered from the lingering effects of discrimination so as to justify inclusion in a racial preference program extending to the defense industry.

Moreover, since the 1207 program incorporates its presumption of social and economic disadvantage from §8(d), any constitutional defects in enactment of §8(d) are
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Rothe Development Corp. v. DOD (cont'd):

relevant to the court's analysis. The United States Court of Appeals for the Tenth Circuit held in Adarand VII that to be narrowly tailored, there must be an individualized showing of economic disadvantage for each minority in the §8(d) program. Adarand VII, 228 F.3d at 1184 (“[W]e must conclude, under Croson, that the §8(d) method of certification . . . is not narrowly tailored insofar as it obviates an individualized inquiry into economic disadvantage.”). The court said that to require “a separate showing of [economic and social] disadvantage [such as a short narrative statement of economic disadvantage faced] would help address the Court’s concern in Croson that a government entity undertake the necessary administrative effort ‘to tailor remedial relief to those who truly have suffered from the effects of prior discrimination.’” Id. (citing Croson, 488 U.S. at 508).²²

Conclusion

Because the district court failed to analyze the constitutionality of the 1207 program under the strict scrutiny analysis required by the Supreme Court in Croson and Adarand, and relied on post-reauthorization evidence to determine the constitutionality of the 1207 program as reauthorized, we vacate the district court’s judgment and remand for the requisite findings to be made.

VACATED AND REMANDED.

Footnotes

¹ - The bill passed by the House contained a provision mandating that ten percent of each of the amounts appropriated for the DOD in procurement, research, development, test and evaluation, military construction, and operations and maintenance be set-aside for SDBs. H.R. Conf. Rep. No. 99-1001, at 524, reprinted in 1986 U.S.C.C.A.N. 6529. The Senate bill, which became law, replaced the mandated ten percent set-aside with a “goal” that five percent of the total combined amount of contracts and subcontracts let by the DOD be awarded to SDBs. Id.

² - The statute authorizes several approaches to attaining the five percent goal, such as technical assistance, modification of competitive procedures, advance payments, and contracting with historically minority educational institutions. 10 U.S.C. §§2323(a), (c), (e).

³ - To be consistent with the district court opinion and the practice of the parties, all citations related to the 1207 program are, unless otherwise noted, to regulations as they existed and were codified at the time of contract solicitation. Many of these regulations and statutes have been modified since.

⁴ - The groups included are the following: Black Americans; Hispanic Americans; Native Americans (American Indians, Eskimos, Aleuts, or Native Hawaiians); Asian-Pacific Americans (persons with origins from Burma, Thailand, Malaysia, Indonesia, Singapore, Brunei, Japan, China (including Hong Kong), Taiwan, Laos, Cambodia (Kampuchea), Vietnam, Korea, the Philippines, U.S. Trust Territory of the Pacific Islands (Republic of Palau), Republic of the Marshall Islands, Federated States of Micronesia, the Commonwealth of the Northern Mariana Islands, Guam, Samoa, Macao, Fiji, Tonga, Kiribati, Tuvalu, or Nauru); and Subcontinent Asian Americans (persons with origins from India, Pakistan, Bangladesh, Sri Lanka, Bhutan, the Maldives Islands or Nepal). 13 C.F.R. part 124.103(b) (1998).

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Rothe Development Corp. v. DOD (cont'd):

5 - Although the Fifth Amendment does not contain an express equal protection clause, the Supreme Court has read into the Fifth Amendment's Due Process Clause an equal protection component. See Schneider v. Rusk, 377 U.S. 163, 168 (1964) (“[W]hile the Fifth Amendment contains no equal protection clause, it does forbid discrimination that is ‘so unjustifiable as to be violative of due process.’”) (internal citation omitted).

6 - Section 5 of the Fourteenth Amendment states: “Congress shall have the power to enforce, by appropriate legislation, the provisions of this Article.” U.S. Const., Amend. XIV, §5. Section 1 of the Fourteenth Amendment, of course, prohibits discrimination by the states.

7 - In Croson, the city of Richmond, Virginia, adopted a Minority Business Utilization Plan in response to claims that the city had discriminated on the basis of race in the letting of city contracts, or at least that prime contractors had discriminated against minority subcontractors. Croson, 488 U.S. at 469.

8 - In Metro Broadcasting, the Court considered the constitutionality of two minority preference programs adopted by the Federal Communications Commission. Metro Broadcasting, 497 U.S. at 552.

9 - Like the 1207 program, the program at issue in Adarand was also enacted by Congress. At issue in the case was the constitutionality of the Subcontractor Compensation Clause (“SCC”), which employed race-conscious presumptions designed to favor minority enterprises and other “disadvantaged business enterprises” (“DBEs”). Adarand III, 515 U.S. at 209. In the case, the Central Federal Lands Highway Division, which is part of the Department of Transportation (“DOT”), awarded a prime contract for a highway construction program in Colorado to Mountain Gravel & Construction Company. Id. at 205. Mountain Gravel solicited bids from subcontractors for the guardrail portion of the contract. Id. Adarand, a Colorado-based highway construction company, submitted the lowest bid, but the contract was awarded to a construction company owned by an Hispanic American. Id. The United States Court of Appeals for the Tenth Circuit had initially affirmed the district court's decision upholding the constitutionality of the program. Adarand Constructors, Inc. v. Pena, 16 F.3d 1537 (10th Cir. 1994) (“Adarand II”). The Supreme Court reversed and remanded. Adarand III, 515 U.S. at 227. On remand, the district court held the SCC program unconstitutional, finding that it was not narrowly tailored. Adarand Constructors, Inc. v. Pena, 965 F. Supp. 1556 (D. Colo. 1997) (“Adarand IV”). On September 25, 2000, the Tenth Circuit held that there was evidence that Congress had a compelling interest in enacting the SCC program; the court also held that while the challenged 1996 SCC program was not narrowly tailored, the current program is narrowly tailored. Adarand Constructors, Inc. v. Slater, 228 F.3d 1147 (10th Cir. 2000) (“Adarand VII”). On March 26, 2001, the Supreme Court granted certiorari to hear Adarand VII. Adarand Constructors, Inc. v. Slater, 2001 WL 369474 (2001). The writ was limited to two questions: (1) “Whether the court of appeals misapplied the strict scrutiny standard in determining if Congress had a compelling interest to enact legislation designed to remedy the effects of racial discrimination”; and (2) “Whether the United States Department of Transportation's current [DBE] program is narrowly tailored to serve a compelling governmental interest.” Id. (as amended on April 13, 2001).

10- The Supreme Court's opinion in Adarand III is a majority opinion as to all parts, except to Part III-C, which is a plurality opinion authored by Justice O'Connor and only joined by Justice Kennedy. All references to Adarand are to the majority opinion, except where noted.

11- The Adarand Court declined to explicate the precise analysis applicable to a federal racial classification. Instead, the Court vacated the decision of the United States Court of Appeals for the Tenth Circuit and remanded the case “for further consideration in light of the principles we have announced.” Adarand III, 515 U.S. at 237.

12 - In Fullilove, the Court applied intermediate scrutiny to a racial classification enacted by Congress pursuant to its powers under §5 of the Fourteenth Amendment. Chief Justice Burger, writing for the plurality, said that a program enacted by Congress warranted deferential review: “A program that employs racial or ethnic criteria, even in a remedial context, calls for close examination; yet we are bound to approach our task with appropriate deference to the Congress, a co-equal branch charged by the Constitution to . . . ‘enforce, by appropriate legislation,’ the equal protection guarantees of the Fourteenth Amendment.” Fullilove, 448 U.S. at 472.

13 - Although Justice O'Connor authored the majority opinion in Croson, there are two separate parts of the opinion to which only a plurality joined: 1) Part II which was joined by Chief Justice Rehnquist and Justice White; and 2) Parts III-A and V, joined by Chief Justice Rehnquist, and Justices White and Kennedy.

14 - That Congress is entitled to no deference in its ultimate conclusion that race-based relief is necessary does not mean that Congress is entitled to no deference in its factfinding. See Croson, 488 U.S. at 500 (“The factfinding process of legislative bodies is generally entitled to a presumption of regularity and deferential review by the judiciary.”).

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Rothe Development Corp. v. DOD (cont'd):

¹⁵ - We recognize that a governmental body reauthorizing an edict -- for example, Congress reauthorizing a statute - has the opportunity to inspect all evidence post-dating enactment but pre-dating reauthorization. That is, for the purpose of considering congressional motivation, the process of reauthorization is equivalent to simultaneously allowing a statute to lapse and re-enacting it. Therefore, in assessing the constitutionality of a statute in an equal protection context, a reviewing court should be able to consider all evidence available to Congress pre-dating the most recent reauthorization of the statute at issue. The contract at issue in this case was solicited and awarded in 1998. Therefore, in considering the constitutionality of the 1207 program as applicable to the contract awarded to ICT, the district court should consider evidence available to Congress that pre-dates the 1992 reauthorization.

¹⁶ - The §8(a) program is a business development program aimed at helping minorities who are the most disadvantaged. In order to participate in the § 8(a) program, one must have a personal net worth of less than \$250,000. 13 C.F.R. §124.106.

¹⁷ - Moreover, the evidentiary record, as presented by the district court, might, we think, be insufficient even if we evaluated the 1207 program under the more lenient standard of rational basis scrutiny, whereby a classification would be upheld so long as there is a rational relationship between the disparity of treatment and some legitimate governmental purpose. Recently, in Board of Trustees of the University of Alabama v. Garrett, 121 S.Ct. 955 (2001), the Supreme Court held that even under rational basis scrutiny, the evidentiary record assembled to support a disability classification was inadequate, as Congress had not “identified a history and pattern of unconstitutional employment discrimination by the States against the disabled.” *Id.* at 967-68 (noting that even if the half dozen examples of discrimination “showed unconstitutional action on the part of the States, these incidents taken together would fall far short of even suggesting the pattern of unconstitutional discrimination on which §5 legislation must be based”).

¹⁸ - The court specifically stated, however, that it did not rely on the statistical evidence presented by the AALDEF. Rothe I, 49 F. Supp.2d at 947 n.8.

¹⁹ - Although the issue in Shaw (racial gerrymandering) is different from the issue here (public contracting), we know from the Supreme Court’s practice that it is appropriate to rely on precedents from other factual situations (such as employment, gerrymandering, or education) in determining whether the racial classification in contracting is constitutional. Therefore, we cite and rely on decisions arising in other factual situations for what those opinions reveal on the constitutionality of racial classifications in all factual settings.

²⁰ - See Associated Gen. Contractors of Ohio, Inc. v. Drabik, 214 F.3d 730, 738 (6th Cir. 2000) (noting that the district court did not err in refusing to allow the state’s motion for a continuance to supplement the existing data, because “under Croson, the state must have had a sufficient evidentiary justification for the racially conscious statute in advance of its passage; the time of a challenge to the statute, at trial, is not the time for the state to undertake factfinding.”); Associated Utility Contractors of Md., Inc. v. Mayor and City Council of Balt., Inc., 83 F. Supp.2d 613, 621 n.6 (D. Md. 2000) (disagreeing with decisions of several other courts finding post-enactment admissible in the Croson analysis, because the Supreme Court has “provide[d] controlling authority on the role of post-enactment evidence in the ‘strong basis in evidence’ inquiry”); W. Tenn. Chapter of Associated Builders and Contractors, Inc. v. City of Memphis, 138 F.Supp.2d 1015, 1022 (W.D. Tenn. 2000) (holding that the use of post-enactment evidence “in determining whether the legislative body . . . had a strong basis in evidence of past discrimination before implementing the plan, is antithetical to equal protection doctrine,” but that it could be used to “supplement the statistical foundation showing the City’s passive or active discriminatory practices”).

²¹ - If the district court relied on the post-enactment evidence offered by the AALDEF simply to supplement a constitutionally sufficient pre-reauthorization record, we do not think such use would be improper under our holding today. However, although the district court first used the term “bolster,” in a footnote, it explicitly stated that it was relying on the AALDEF’s brief in “determining” that the government acted with a compelling interest. Rothe I, 49 F. Supp.2d at 946 n.8. We take this statement to mean that the district court relied on post-enactment evidence to satisfy the legislature’s duty under Croson to have a “strong basis in evidence” for racial discriminatory conduct.

²² - In 2000, new regulations extended the individualized determination of economic disadvantage in §8(a) to §8 (d). See Adarand VII, 228 F.3d at 1185; 13 C.F.R. §124.1002(a) (2000) (incorporating §8(a) criteria from 13 C.F.R. pt. 124, subpt. B); 48 C.F.R. §19.703 (2000) (eliminating the race-based presumption of economic disadvantage of the former regulation); 13 C.F.R. § 124.104(b)(1) (2000) (requiring submission of a narrative statement of purported economic disadvantage for each group). At the time of the contract award in this case, in 1998, however, §8(d) did not include a requirement of an individualized showing of economic disadvantage.

Believe That Change Has Come For Contractors

by
David Nadler
and
Joseph Berger*

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President-elect Barack Obama and his administration will face significant challenges implementing their campaign agenda on government contracting, but they have a head start because of trends Congress has already set in motion.

At the same time, the new government's contractors will face their own set of corresponding challenges resulting from regulatory and legislative changes, increased oversight and enforcement, and budget cuts.

In September 2008, Obama released a reform agenda that included proposals for improving government contract management and oversight capacity, minimizing no-bid and cost-plus contracts, reducing spending on federal contracts, increasing transparency, and cracking down on tax-delinquent contractors. The new president will have broad authority to set procurement policies and priorities through the Office of Management and Budget and its Office of Federal Procurement Policy.

Congress already has tackled some of the issues in Obama's reform agenda through provisions of the National Defense Authorization Acts for Fiscal Years 2008 and 2009, many of which apply to government-wide contracting, with provisions to be implemented first by the new administration. In the 2009 defense act, enacted in October, Congress continued its focus on contracting issues addressed in last year's defense act. These laws have begun changes to contracting rules that will continue into the new administration, in addition to the new changes that the Obama administration adopts.

OBAMA'S REFORM AGENDA

Because both presidential candidates were sitting senators, they were familiar with the contracting issues facing the next administration and addressed them during the campaign.

Obama's reform agenda pledged to "end abusive no-bid contracts and minimize the use of cost plus contracts." Obama and the recent legislation both seek to increase competition for government contracts, which generally means more opportunities for contractors.

The 2009 defense act limited the length of certain noncompetitive contracts and the use of the "unusual and compelling urgency" justification for their award under the Competition in Contracting Act of 1984. An agency using this justification must limit the contract to a duration no longer than necessary, which must be less than one year, unless the head of the agency grants an exception.

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Believe That Change Has Come For Contractors (cont'd):

Obama's reform agenda proposed to "require each federal agency to defend each of its noncompetitive contracts to the Office of Management and Budget," a pledge that complements the new law.

The 2009 defense act gives the agency council that oversees the Federal Acquisition Regulation one year to amend the FAR to require competition for purchases over \$100,000 under multiple award contracts throughout the government. The 2008 defense act created similar competition requirements for orders greater than \$5 million and promoted the use of multiple awards to allow that competition.

The new competition requirements will increase the administrative burden on the president-elect's acquisition workforce, but they will give the holders of widely prevalent multiple-award contracts more opportunities to compete.

Although Obama proposed to ensure competition for purchases above \$25,000, the new requirements of the act aid him in fulfilling his pledge to protect competition.

The 2009 act also requires new FAR regulations on the use of cost-reimbursement contracting, to be published within 270 days, which will be completed under the new administration. The OMB director must report annually to Congress on the use of cost contracts under the new regulations.

Obama's reform agenda, proposing to minimize cost contracts, stated that he would "encourage the use of fixed-cost or incentive-based contracts and when cost-plus contracts are necessary, force agencies to use mitigating procedures like incentives tied to performance goals and cost savings." (Sen. John McCain, during the presidential debates, highlighted a similar intention to replace cost contracts with fixed-price contracts.) Obama may fulfill his pledge through the new regulations on cost contracting that his administration will issue and oversee.

Obama's reform agenda noted that spending on contracts more than doubled under the Bush administration, from \$203 billion in 2000 to \$412 billion in 2006. It proposed to cut federal spending on contracts by at least 10 percent. This proposal will be part of the inevitable budget-cutting process facing the next administration, as it addresses the record deficit, the implications of the financial crisis, and the costs of the government bailout package. Spending on contracts reached new highs in fiscal year 2008 and has been projected to decline. Federal contractors, like other sectors of the economy, are sure to face a squeeze, but they will remain integral to the work of the new government, aiding it in every agency and in policy execution from defense and homeland security to health care, energy independence, and the financial rescue.

RESTORING OVERSIGHT

Obama's agenda pledged to "restore management and oversight capacity," stating that "the
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Believe That Change Has Come For Contractors (cont'd):

federal government's ability to manage contracts has not kept up with the increase in the volume and complexity of federal contracts." Again, the president-elect may have a head start: The 2008 defense act created an annual defense acquisition workforce development fund to increase hiring and improve training. The next administration should prioritize funding for improvements to the procurement workforce of the defense and civilian agencies. Government contractors stand to benefit from better administration of their contracts, which can prevent unnecessary contract disputes.

Obama's proposals could mean that more work that has been, or could be, done by contractors will instead be done by the federal government. Obama's agenda stated that "federal agencies are increasingly seeking to contract out functions that should be done by the government." The 2009 defense act requires the OMB to review existing definitions of "inherently governmental" functions as they are employed in federal outsourcing activities, develop guidelines on positions that should be performed by government employees, report recommendations to Congress within one year, and then adopt by regulation a new definition and guidelines. The next administration may slow or reverse the Bush administration's policies that promoted outsourcing of federal work to contractors.

Obama's agenda proposed to require audits of a quarter of large contracts each year, focusing on noncompetitive and cost-plus contracts. Similar congressional audit initiatives have recently focused on war-zone contracts. According to an August 2008 report by the Congressional Budget Office, spending on contractors in Iraq will reach \$100 billion by the end of the Bush administration. The 2008 defense act required new audits of contracts for logistical support of coalition forces and reconstruction in the war zones, and it created a congressional Commission on Wartime Contracting, with an interim report due soon after the new president takes office. Supervisors of government auditors, meanwhile, have been subject to recent congressional inquiry and criticism for episodes of soft enforcement.

Contractors should brace themselves for increased oversight and enforcement through investigations and audits throughout the new government, including by agencies' inspectors general. The leaders of the next administration, for their part, should strive for a fair and evenhanded approach to their new authorities.

The president-elect also may revisit his own past legislative initiatives to improve transparency in contracting, initiatives that were touted in his reform agenda. Obama and McCain, among others, co-sponsored the Federal Funding Accountability and Transparency Act of 2006, which created the Web site USAspending.gov that details the use of federal funds on contracts and grants. Obama and McCain co-sponsored new legislation in June 2008 to broaden the database with new information on awards and contractors, including the contract itself. Both contractors and the government may face increased public scrutiny as a result.

Obama's reform agenda also stated that he "will build upon his work in the Senate to prohibit seriously [tax] delinquent contractors" from new government contracts.
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Believe That Change Has Come For Contractors (cont'd):

PENDING CHALLENGES

Under each new administration, executive branch actions on contracts and awards remain subject to scrutiny from the courts and the Government Accountability Office, an arm of Congress. With proposals to ensure competition, the new administration must devote adequate resources to ensure a fair process. The incoming administration will also inherit pending procurements, such as a competition for the next generation of the Air Force's aerial refueling tankers. In September 2008, the Department of Defense canceled the solicitation for the tanker because the department could not complete the competition before the new administration takes office. The high-stakes contract was awarded in February 2008 to Northrop Grumman Corp., and rival Boeing Co. protested the award to the GAO, which sustained the protest in June 2008. The new administration must facilitate a new selection process that will withstand scrutiny by both the GAO and Congress.

Another challenge facing the next administration and its contractors is the next set of initiatives from the new Congress. Congress is likely to act again soon on many issues affecting contractors. Possible legislation includes pending bills seeking to overhaul the False Claims Act. The proposed amendments have been criticized by the business community, and government contractors could be faced with a new, uncertain legal regime, in addition to stepped-up enforcement.

Change is a constant aspect of the business of government contracting. Some changes are already in motion; others will arrive soon. The new administration will need to work with its contractors to accomplish its broader policy goals. Both the government and its contractors should prepare for the new administration and its reform agenda.

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***Allison Engine: The Supreme Court
Addresses Liability Under the False Claims Act***

by
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and
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After a hiatus of 30 years, the Supreme Court has decided a case addressing the liability provisions of the False Claims Act (FCA), *Allison Engine Co. v. United States ex rel. Sanders*.¹ The Court's unanimous decision came as a surprise, bypassing circuit court precedent and instead establishing a new test for liability under FCA sections (a)(2) and (a)(3) in situations where claims are presented to third parties rather than directly to the United States. Concerned that the FCA should not be read broadly as an "all purpose anti-fraud statute," the Court held that the statute requires proof that "the defendant intended that the false record or statement be material to the government's decision to pay or approve the false claim." Under this standard, liability is foreclosed where "the direct link between the false statement and the government's decision to pay or approve a false claim is too attenuated to establish liability." Although it is impossible to predict how the lower courts will interpret and apply the Supreme Court's decision, it is clear that the decision will have an impact on cases asserted against subcontractors and other defendants that submit claims to intermediary entities rather than directly to the United States. This article discusses the case and some of its possible ramifications.

Background

In 1985, the United States Navy entered into contracts with two shipyards to build Arleigh Burke-class destroyers. The shipyards subcontracted with Allison Engine to build electrical generator sets for the ships, and Allison Engine subcontracted with a lower-tier subcontractor. The Navy's contract with the shipyards required that the generator sets be built according to Navy drawings and military standards, and these requirements were incorporated into the subcontracts. The Navy's contract also required that every generator set be delivered with a "certificate of conformance" certifying that the unit was manufactured in accordance with contract requirements.

In 1995, former employees of Allison Engine's subcontractor filed a qui tam action under the FCA, 31U.S.C. §§3729 *et seq.*, alleging that Allison Engine and its subcontractors had violated sections (a)(1), (a)(2), and (a)(3) of the statute by knowingly submitting invoices for generator sets not conforming to the Navy's specifications. At trial, the relators introduced evidence that the subcontractors had submitted certificates of conformance and invoices for payment *to the shipyards*. However, the relators failed to introduce into evidence any of the invoices submitted by the shipyards *to the Navy*. Thus, although there was evidence that Allison Engine and its subcontractors had been paid with federal funds, there was no evidence of any false claim presented directly to the government.²

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Allison Engine (cont'd):

The district court granted the contractors' motion for judgment as a matter of law due to the relators' failure to prove direct "presentment" of a claim to the government.³ On appeal, a divided panel of the Sixth Circuit reversed.⁴ The Sixth Circuit acknowledged that section (a)(1) of the FCA requires proof of direct presentment of a claim to the government, but held that liability under sections (a)(2) and (a)(3) of the statute did not require proof of presentment. Instead, the court looked to the broad definition of "claim" in section 3729(c) and held that liability under sections (a)(2) and (a)(3) only required proof "that the claim was paid with government funds."⁵ As the Sixth Circuit acknowledged, this holding directly conflicted with the D.C. Circuit's earlier decision in *United States ex rel. Totten v. Bombardier Corp.*,⁶ which had held (in an opinion authored by then-Judge Roberts) that sections (a)(2) and (a)(3) required proof of presentment.

The issue before the Supreme Court, then, seemed relatively straightforward. Would the Court accept the D.C. Circuit's interpretation of the FCA and require proof of presentment to establish liability under sections (a)(2) and (a)(3)? Or would the Court instead accept the Sixth Circuit's interpretation and require only proof that a claim had been paid with funds derived from the federal treasury?

The Supreme Court's Opinion

The Supreme Court's answer was "none of the above." The Court's opinion began by rejecting both the Sixth Circuit and D.C. Circuit interpretations. Responding to the Sixth Circuit, the Court held that it was not enough under section (a)(2) "to show that a false statement resulted in the use of government funds to pay a false or fraudulent claim."⁷ That interpretation, the Court reasoned, was contrary to the text of section (a)(2), which required proof that a contractor knowingly made or used a false record or statement "to get a false or fraudulent claim paid or approved by the Government."⁸ "To get" denotes purpose," the Court stated, and mere proof that federal funds were used to pay a false claim was insufficient to establish that purpose.⁹

Rejecting the D.C. Circuit position, the Court continued: "This does not mean, however, . . . that § 3729(a)(2) requires proof that a defendant's false record or statement was submitted to the Government."¹⁰ The Court based its reading on the text of the statute: "The inclusion of an express presentment requirement in subsection (a)(1), combined with the absence of anything similar in subsection (a)(2), suggests that Congress did not intend to include a presentment requirement in subsection (a)(2)."¹¹

The proper standard, the Court concluded, focused on the subcontractor's intent. For liability to attach under section (a)(2), there must be proof that "the defendant intended that the false record or statement be material to the Government's decision to pay or approve the false claim."¹² Thus, "a subcontractor violates § 3729(a)(2) if the subcontractor submits a false statement to the prime contractor intending for the statement to be used by the prime contractor to get the government to pay its claim."¹³ By contrast, if the subcontractor makes a false statement to the prime but "does not intend that the Government rely on that false
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Allison Engine (cont'd):

statement as a condition of payment,” it is not actionable. The Court noted that a broader reading of the statute to encompass “fraud directed at private entities would threaten to transform the FCA into an all-purpose antifraud statute.”¹⁴

The Court reached a similar conclusion under the conspiracy provision of the FCA, section 3729(a)(3), which imposes liability on a person who “conspires to defraud the Government by getting a false or fraudulent claim allowed or paid.” The Court found that liability requires more than a showing of a “fraud scheme that had the effect of causing a private entity to make payments using money obtained from the Government.” Instead, “it must be established that [the conspirators] agreed that the false record or statement would have a material effect on the Government’s decision to pay the false or fraudulent claim.”¹⁵

Having articulated these standards, the Court remanded the case for further proceedings.

Effect on Subcontractors

The *Allison Engine* decision should not be read as a “Get-Out-of-Jail-Free” card for subcontractors. To the contrary, there are scores of cases imposing liability on subcontractors under sections (a)(1), (a)(2), and (a)(3) of the FCA, and nothing in *Allison Engine* indicates that subcontractors will be able to evade liability merely because their claims are presented to a prime contractor or upper-tier subcontractor. It is worth looking at the way that liability can be imposed on subcontractors under the three sections of the statute, in the wake of *Allison Engine*.

Section (a)(1). A prime contractor can face liability by knowingly presenting false claims to the government. A subcontractor can face liability by “causing” a prime contractor to present false claims to the government. Thus, a subcontractor that knowingly delivers goods that do not meet material contract requirements, or that knowingly overbills for goods or services, will be held liable if its actions are deemed to “cause” the prime contractor’s claim to be false. However, the subcontractor will not be found liable if (as in *Allison Engine*) the plaintiff fails to provide evidence of the claims presented by the prime contractor to the government. Those claims presented directly to the government remain the linchpin of liability. The Supreme Court expressly confirmed that under section (a)(1), direct “presentation” of a claim to the government is an element of liability.

Section (a)(2). A prime contractor can face liability by knowingly making or using false statements or records to get its false claims paid by the government. A subcontractor can face liability by: (1) knowingly making or using a false statement or record; (2) intending that its false statement or record be used by the prime contractor to get the government to pay the prime contractor’s claim; and (3) intending that its false statement or record be material to the government’s decision. The significant open question, not addressed by the Supreme Court, is the kind and amount of evidence that will be required to prove the requisite “intent.” The Court made clear that it is not necessary that plaintiffs prove that the subcontractor’s false statement was presented directly to the United States, although presumably such direct
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Allison Engine (cont'd):

presentment could constitute evidence of the requisite “intent.”

Section (a)(3). A prime contractor can face liability by conspiring to defraud the government to get a false or fraudulent claim paid. A subcontractor can face liability by: (1) conspiring to defraud the government; (2) intending that the subcontractor’s false record or statement be used by the prime contractor to get the government to pay the prime contractor’s claim; and (3) intending that the false record or statement be material to the government’s decision. Again, the open question is the kind and amount of evidence that will be required to prove the requisite “intent.”

Effect on Recipients of Federal Grants

The *Allison Engine* Court’s “intent” test may have the most significant impact on federal block grants—money given by the federal government to state agencies or private intermediaries. Recipients of block grants are typically free to disburse the money as they see fit, with no need to seek reimbursement or approval from the federal government for particular expenditures. Under *Allison Engine*, it is not clear what kind of proof plaintiffs will be able to adduce that a person submitting a claim to the recipient of a block grant “intends” for the federal government to pay a claim, where the federal government will never see any claims. The answer may depend in part on whether the federal government has imposed conditions on disbursements from a block grant, and whether a claimant (such as a contractor) makes false statements to the grant recipient to evade those conditions.

Effect on “Materiality” Requirement

Prior to *Allison Engine*, virtually all appellate and district courts were in agreement that the FCA imposes liability only where the defendant’s alleged misconduct is “material” to the government’s decision to pay the claim.¹⁶ The Supreme Court laid to rest any further debate as to the presence of a materiality requirement in sections (a)(2) and (a)(3), by finding a materiality requirement in the statute based on the words “to get” and “getting” in those sections.

Because the Court did not expressly state that materiality is also an element of liability under section (a)(1), relators may argue that no such requirement should apply to that section. It seems unlikely, however, that such arguments would prevail. The lower courts have uniformly found a materiality requirement in the phrase “false or fraudulent claim,” which is found in sections (a)(1), (a)(2), and (a)(3). For example, one court read that phrase as “implicitly requir[ing] statements or conduct that are material to the person’s entitlement to the money or property claimed before liability arises.”¹⁷ Nothing in the Supreme Court’s decision would suggest a reinterpretation of that phrase.

The Supreme Court did not shed any direct light on a question that has bedeviled many courts—the definition of “materiality.” Some courts have held that materiality should be assessed based on an objective standard of “the potential effect of the false statement when it is made,”¹⁸ and have only required proof that a misrepresentation have a “natural tendency” to influence the government’s decision to pay.¹⁹ Other courts have in practice adopted a higher
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Allison Engine (cont'd):

standard of proof, requiring a showing that a false statement was *actually* important or relevant to the government's decision to pay the claim in question.²⁰ Several parts of the *Allison Engine* decision strongly suggest that the Court would agree that a higher standard must be established. For example, the Court found there must be a "direct link between the false statement and the government's decision to pay or approve a false claim," and found that a defendant should not be answerable for "anything beyond the natural, ordinary, and reasonable consequences of his conduct."²¹

Cases Applying *Allison Engine*

Several district courts have already issued opinions applying the standards set forth in *Allison Engine*. In some cases, the decision played only a minor role. For example, in *Raghavendra v. Trustees of Columbia University*,²² a former Columbia University employee brought an FCA claim against Columbia for discriminating against him while receiving federal funds; the theory was that Columbia had received funds by misrepresenting to the government that it was an equal-opportunity employer. The district court dismissed the FCA claim, holding that "[i]t simply is not the law . . . that any disgruntled employee who works for an entity receiving federal dollars can adequately plead an FCA claim by stating that the employer accepted federal dollars and treated its workers unfairly."²³ Although the court cited *Allison Engine* for this holding, the employee's claim (which was also deficient in a number of other respects) would likely have been dismissed absent the Supreme Court's recent decision.

A more substantial discussion of *Allison Engine* is found in *United States ex rel. Romano v. New York-Presbyterian Hospital*.²⁴ There, a relator contended that New York-Presbyterian Hospital had submitted false claims seeking Medicaid funds. Under the Medicaid program, the federal government gives advance funds to state Medicaid agencies, and hospitals that service Medicaid recipients can submit claims to the agencies for reimbursement. At the end of every quarter, the state agencies submit an aggregate report to the federal government, which reconciles actual expenditures with the advanced funds. The hospital sought summary judgment because payment decisions under Medicaid are made by the state agencies, not the federal government, and because it presented no claims directly to the federal government. The district court denied summary judgment, noting that under *Allison Engine* FCA liability could exist without direct presentment of claims, and further noting that the question of the hospital's "intent" when it submitted its claims to the state Medicaid agency was a question of fact that should be resolved at trial.

The most significant discussion of *Allison Engine* to date is in *United States v. Hawley*.²⁵ That case involved the government's crop insurance program under which private insurers sell and service policies to individual farmers, and the government reimburses the insurers for any indemnity payments they make. The defendants in *Hawley* were a private insurance agency and its principal, who served as intermediaries between farmers seeking crop insurance and private companies issuing the policies. The defendants allegedly submitted several false crop insurance applications to insurers in the name of individual farmers who did not actually have any interests in crop land; the defendants received commissions when the private insurers accepted
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Allison Engine (cont'd):

those applications and issued policies. These farmers eventually received indemnity payments from the insurers for claimed crop losses, and the insurers were reimbursed by the government. The government sued the defendants under sections (a)(1), (a)(2), and (a)(3) of the FCA.

Relying on *Allison Engine*, the district court *sua sponte* granted summary judgment to defendants on all three counts. On the section (a)(1) claim, the court noted that *Allison Engine* required direct presentment of a claim to the government, which could not be established where the defendants had submitted claims only to private insurers, not the government. On the section (a)(2) claim, the court acknowledged that “the government ultimately reimbursed [the private insurer] for the false claims that [the insurer] paid,” but held that this reimbursement was insufficient to support the “intent” requirement established in *Allison Engine*. The court noted that “the allegedly false crop insurance claims themselves were never forwarded to or approved by the government, nor was the payment of the crop insurance claims conditioned on review or approval by the government, and there is no showing that the defendant intended that the false records or statements would be material to the government’s decision to pay or approve the false claim.”²⁶ The court reached a similar conclusion as to the section (a)(3) claim.²⁷

Effect on Proposed FCA Amendments

Aside from its effect on FCA jurisprudence, the Supreme Court’s *Allison Engine* decision is significant for a different reason: it coincides with a significant movement in Congress to amend the FCA. As of this writing, both houses of Congress are currently considering the False Claims Act Corrections Act of 2007, in the form of H.R. 4854 in the House and S. 2041 in the Senate. Among a laundry list of other items, both bills include provisions designed to eliminate any presentment requirement in the FCA. The House bill would impose FCA liability for any false claims “for Government money or property,” which is defined broadly to include not just money or property held by the government itself, but also “money or property the United States Government provides, has provided, or will reimburse to a contractor, grantee, agent or other recipient to be spent or used on the Government’s behalf or to advance Government programs.”²⁸ The Senate bill, as amended, removes the “presentment” language from section (a)(1), and broadly redefines “claim” to include claims made to contractors, grantees, or other recipients, if the government: “(I) provides or has provided any portion of the money or property requested or demanded; or (II) will reimburse such contractor, grantee or other recipient for any portion of the money or property which is requested or demanded. . . .”²⁹

Although there is some question about how the language of these competing bills would be interpreted, these bills might revive the Sixth Circuit’s interpretation of the current FCA and allow liability to encompass false claims so long as the claim was paid using federal funds. The language may sweep even more broadly, and could conceivably encompass claims for virtually any funds that are in any way derived from the federal government, dramatically expanding the current scope of the FCA. If enacted, these bills would transform the FCA into the type of law the Supreme Court warned against: an “all-purpose antifraud statute.”

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Because *Allison Engine* overruled the *Totten* case and eliminated any suggestion that FCA liability depends on proof of direct presentment (other than under section (a)(1)), the original impetus for this amendment no longer exists. On the other hand, the Supreme Court's "intent" test may not go as far as the expansive language in the proposed bills. Thus, it remains to be seen whether *Allison Engine* cools or fuels Congress's reformist zeal.

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Endnotes

1. 128 S. Ct. 2123, 170 L. Ed. 2d 1030 (2008).
2. This, at least, was how the Supreme Court described the facts. At oral argument before the Court, however, the relators' attorney caused a minor stir when he suggested that—contrary to the justices' understanding of the case—*Allison Engine* had directly presented certain false claims to the Navy by presenting fraudulent certificates of conformance. "Then there's less to this case than we had thought," Justice Scalia replied, "My goodness, even under [Allison's] theory, you win." Chief Justice Roberts also speculated that "the question presented in this case is not in fact presented here." Ultimately, however, this attempt to divert the justices from ruling on the question presented was unavailing.
3. United States *ex rel.* Sanders v. Allison Engine Co., Inc., 2005 WL 713569 (S.D. Ohio 2005).
4. United States *ex rel.* Sanders v. Allison Engine Co., Inc., 471 F.3d 610 (2006).
5. *Id.* at 615.
6. 380 F.3d 488 (D.C. Cir. 2004).
7. 128 S. Ct. at 2128.
8. *Id.*
9. *Id.*
10. *Id.* at 2129.
11. *Id.*
12. *Id.* at 2126.
13. *Id.* at 2130.
14. *Id.*
15. *Id.* at 2130-31.
16. See, e.g., United States *ex rel.* Berge v. Board of Trustees of Univ. of Ala., 104 F.3d 1453, 1459 (4th Cir.); United States v. Southland Mgmt. Corp., 326 F.3d 669, 679 (5th Cir. 2003); Luckey v. Baxter Healthcare Corp., 183 F.3d 730, 732-33 (7th Cir. 1999); United States v. Data Translation, Inc., 984 F.2d 1256, 1266-67 (1st Cir. 1992); United States *ex rel.* Costner v. United States, 317 F.3d 883, 886-87 (8th Cir. 2003); Tyger Constr. Co. v. United States, 28 Fed. Cl. 35, 55 (1993); United States v. TDC Mgmt. Corp., 24 F.3d 292, 296, 298 (D.C. Cir. 1994).
17. United States *ex rel.* Wilkins v. North Am. Constr. Corp., 173 F. Supp. 2d 601, 624 & n.19 (S.D. Tex. 2001).
18. United States *ex rel.* Harrison v. Westinghouse Savannah River Co., 352 F.3d 908, 916, 923 (4th Cir. 2003).
19. See United States *ex rel.* A+ Homecare, Inc. v. Medshares Mgmt. Group, Inc., 400 F.3d 428 (6th Cir. 2005); *Harrison*, 352 F.3d at 914; *Berge*, 104 F.3d at 1459-60.
20. E.g., *Wilkins*, 173 F. Supp. 2d at 636-37.
21. 128 S. Ct. at 2130 (citations omitted).
22. 2008 U.S. Dist. LEXIS 51995 (S.D.N.Y. July 2, 2008).
23. *Id.* at *30-*31.
24. 2008 U.S. Dist. LEXIS 54038 (S.D.N.Y. July 15, 2008).
25. 2008 U.S. Dist. LEXIS 49262 (N.D. Iowa June 27, 2008).

Allison Engine (cont'd):

Endnotes (cont'd)

26. *Id.* at *20-*21; *see also id.* at *24-*25.

27. One interesting fact about the *Hawley* case is that, under the crop insurance program, every insured farmer is required to certify that he “understand[s] that this crop insurance is subsidized and reinsured by the [government]”—a fact that the district court expressly acknowledged in an earlier decision. *See United States v. Hawley*, 544 F. Supp. 2d 787, 793 (N.D. Iowa 2008). That certification might be viewed as evidence that the farmer has the requisite intent “to get” a claim “paid or approved by the Government.” But what seemed to ultimately sway the district court was that the government never evaluated the merits of the individual insurance claims submitted by the farmers or the defendant insurer; as a result, it was impossible for any false statements to be “material” to the government’s decision to pay.

28. False Claims Act Corrections Act of 2007, H.R. 4854, 110th Cong. §2 (1st Sess. 2007).

29. False Claims Act Corrections Act of 2007, S. 2041, 110th Cong. §2 (1st Sess. 2007).

The CASB Opus: Harmonizing CAS with the Pension Protection Act

by
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For many government contractors, pension costs are generally the largest single cost element in their labor fringe benefit pool. The changes wrought by the Pension Protection Act¹ have materially impacted the funding of pension plans and required harmonization of the treatment of pension costs under the Cost Accounting Standards, which has caused the Cost Accounting Standards Board to begin its rule-making process in order to determine the changes needed. This article addresses the initial steps of that rule-making process.

I. Background

On August 17, 2006, the Pension Protection Act (PPA) became law.² With massive bipartisan support (the Senate vote was 93-5), the PPA made numerous amendments to the Employee Retirement Income Security Act (ERISA). Since its enactment in 1974, ERISA has been used to ascertain an employer's required minimum contributions to its pension plan. While the PPA's provisions were complex and voluminous (the act runs over a thousand pages), the essential thrust was to require greater contributions into pension plans. Stated briefly, if you were covered by a defined benefit pension plan your employer was going to have to fully fund it earlier.

Although the PPA's amendments to ERISA did not specifically address the concomitant changes to the Cost Accounting Standards (CAS), Congress did not entirely ignore the fact that the PPA would create conflicts with CAS. Rather than legislate a solution, Congress decided instead to task the Cost Accounting Standards Board (CASB) with the responsibility of making the appropriate rule changes to harmonize CAS with the PPA by 2010.

Unfortunately, CASB has a protracted four-step rulemaking procedure. The process requires: (1) a staff discussion paper (SDP); (2) an advance notice of proposed rulemaking (ANPRM); (3) a notice of proposed rulemaking (NPRM); and (4) a final rule. Completion of this process within the congressionally mandated deadline will be a formidable challenge.

Before CASB could even issue its SDP, the Office of Defense Procurement and Acquisition Policy interceded on December 22, 2006, with an agency memorandum. This memorandum addressed the problem of increased costs that contractors would have to pay under the PPA. However, contractors only would be entitled to charge pension costs calculated in accordance with current CAS. The memorandum provided no solution to this dilemma, but merely recommended that auditors coordinate with ACOs on such matters.

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The Defense Contract Audit Agency followed with a corresponding memorandum on May 1, 2007, providing audit guidance on this directive. This DCAA audit guidance, coming from an agency without rulemaking authority, was heavily criticized.³

Because the PPA increased pension contributions beyond what CAS required to fund pension costs, the excess amounts paid by contractors (i.e., the amounts not reimbursed by agencies) were considered by DCAA to be CAS “prepayments.” In fact, CAS prepayments were the difference between what contractors were required to pay under the PPA and what CAS allowed.

DCAA's guidance instructed its auditors to treat these unreimbursed amounts as credits toward a subsequent year's pension obligations. (Previously, such credits were amounts that a contractor had voluntarily paid over its required minimum contribution.) This disconnect between PPA funding and CAS cost recovery adversely influenced the cash flows of affected contractors, i.e., it was not mathematically possible for a contractor to recover all its CAS “prepayments” within a reasonable period unless the plan was terminated.

Shortly after DCAA's audit guidance, on July 3, 2007, CASB issued its SDP.⁴ In its SDP, CASB looked for public comment on whether it would be necessary to revise CAS 412 and CAS 413 to meet the harmonization required by the PPA. DCAA's comment letter to CASB stated that no CAS changes were necessary because the rules already harmonized with the PPA. However, comment letters from industry, actuarial services providers, and others familiar with these pension rules overwhelmingly responded that changes to CAS were necessary to achieve the harmonization intended by Congress.

The CASB staff discussion paper was followed on September 2, 2008 by its ANPRM, the terms of which are discussed in detail below.

II. Pension Protection Act

The legislative intent behind the PPA was the bipartisan concern Congress had about underfunded pension plans becoming a liability of the Pension Benefit Guaranty Corporation (PBGC). Accordingly, the PPA amended ERISA so that, for example, employer contributions would be increased as the act became effective. This goal was accomplished in various ways:

- the discount rate applicable to future liabilities was lowered (note that as the discount rate decreases, the pension liability increases);
- the minimum level for full funding of the liability was increased from 90 percent to 100 percent;
- pension plan assets were to be measured closely to their market values (note that as asset values are tied closer to the market, significantly more volatility is introduced to pension cost measurements); and
- actuarial gains or losses would be amortized over only seven years (note that as amortization periods are shortened, the cost impact is increased).

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The PPA went into effect on January 1, 2008. However, a few of the largest defense contractors, defined as “eligible contractors” in the act, had delayed implementation to 2010, although their subcontractors were affected in 2008.

As noted above, Congress understood that the PPA conflicted with the Cost Accounting Standards but did not specifically direct how to address this problem. Instead, Section 106 of the PPA devised the following resolution:

Cost Account Standard Pension Harmonization Rule.

The Cost Accounting Standards Board shall review and revise sections 412 and 413 of the Cost Accounting Standards (48 CFR 9904.412 and 9904.413) to harmonize the minimum required contribution under the Employee Retirement Income Security Act of 1974 of eligible government contractor plans and government reimbursable pension plan costs not later than January 1, 2010. Any final rule adopted by the Cost Accounting Standards Board shall be deemed the Cost Accounting Standard Pension Harmonization Rule.

As mentioned earlier, the PPA amended ERISA to increase an employer's minimum required contributions to its pension plan. As a collateral matter, there are provisions from the Financial Accounting Standards Board (FASB), the authoritative body that regulates generally accepted accounting principles (GAAP). Financial Accounting Standard (FAS) No. 87 essentially establishes the rules applicable to the financial reporting of pension costs. The PPA sets forth the legal requirements used in calculating the amount of pension contributions, while FAS 87 details how those amounts were to be set forth in financial statements.

As if the regulations in this area were not complex enough, the accounting rules for financial statements were also changed in September 2006 when FASB issued FAS No. 158, *Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans*. This revision by FASB moved from a long-term approach for measuring pension costs to a shorter-term measurement for financial reporting, essentially adopting the market-based perspective used by the PPA. While GAAP determines how pension costs are treated for financial reporting purposes, GAAP is not used for measuring pension costs for government contracts. Rather, the requirements of CAS 412 and 413 (when applicable) are used to calculate allowable pension costs under government contracts.

III. The CASB ANPRM

The most significant problem facing any pension harmonization effort is the applicable period for cost recovery. The PPA shortens the period to require funding, while CAS uses longer periods to recognize the costs of required funding. (By using longer periods for a contractor's recovery of its pension costs, there is more cost smoothing and hence less impact on annual agency budgets.)

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Of course, CASB's harmonization rules will not take effect until 2010 at the earliest, so whatever is decided will not be effective until then. For government contractors, however, 2008 through the end of 2010 will be a period of CAS "prepayments" that are concerned with cost recovery; contractors want to be able to recapture their PPA-required pension funding payments as soon as possible.

The SDP suggested that revisions to CAS 412 and 413 may be necessary to harmonize the standards with the PPA. Section IV of the SDP succinctly stated the problem facing affected government contractors as follows:⁵

IV. ERISA Contributions vs. CAS Cost

ERISA, as amended by OBRA 87 [the Omnibus Budget Reconciliation Act of 1987], obligates plan sponsors, including government contractors, to make minimum pension contributions toward their unfunded accrued benefit liabilities, which are measured on a settlement basis. However, in some cases government contractors are not reimbursed immediately for the higher cash outlays in their government contract costs and prices. Instead, the extra contribution is accounted for as a prepayment credit which is deferred and reimbursed in later years. As a result, many contractors have expressed serious concerns about the detrimental impact on their current cash flow. The PPA may further exacerbate this cash flow issue by increasing the differences between required ERISA funding and the measurable and assignable cost under CAS.

Clearly, the long-term measurement of pension liability under CAS would need to be reconciled with the shorter-term measurement of pension liability under the PPA. However, agencies apparently were concerned about so-called fiscally disruptive "funding spikes," a term that referred to significantly elevated pension costs caused by higher PPA minimum contributions.

These "spikes" could take the form of the immediate short-lived increases in pension costs under a new CAS measurement, or the introduction of ongoing cost volatility should the CAS measurement be tied too closely with the market. There was widespread agreement that any regulatory changes should only be those necessary for harmonization.

Surprisingly, however, the SDP revealed CASB's seeming difficulty with the meaning of harmonization as used in Section 106 of the PPA (Section 106 only applies to single employer defined benefit plans).⁶

Congress instructed the Board to "harmonize" the CAS with the minimum required contribution [under the PPA]. . . .

This leads to the question of what it means to harmonize the two sets of rules.
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On September 2, 2008, CASB announced its ANPRM. The board acknowledged the need to amend CAS 412 and 413, but only with the fewest necessary changes, presumably to expedite the promulgation process to meet the 2010 deadline. In the ANPRM, it was evident that CASB sought to mitigate the immediate effect of increased pension costs on agency budgets. This would be accomplished by establishing a lengthy transition period with a phased-in recognition of the increased pension costs.

Given that industry had vocally expressed the significant materiality of the PPA funding excesses over CAS cost (estimates were in the billions of dollars), the unsurprising CASB response may be overly conservative. CASB's ANPRM sought to mitigate cost volatility and enhance predictability, while providing for only some acceleration of pension cost recovery of the increased funding now required under the PPA.

There are primarily three new mechanisms in the ANPRM that address harmonization. First, a new liability measurement has been added that has a shorter-term approach, like PPA and FASB. However, the existing CAS liability calculation has also been retained. While the two methods of liability measurement yield different results depending on economic circumstances (such as the application of high or low interest rates), contractors will get the higher of the two calculations. This means an increase in pension cost recovery.

Second, funding up to the PPA minimum required amounts (“mandatory prepayment credits”) are amortized over a five-year period, and may be recovered by contractors in addition to CAS pension costs. Accordingly, a contractor whose cash flow has been adversely affected by PPA will begin to see some relief in recovering those funding amounts. In the circumstance where the CAS pension cost exceeds the PPA minimum required funding, the cost recovery of the prepayment is accelerated. Discretionary funding in excess of the PPA minimum required amounts will still be classified as “voluntary prepayments,” which are treated the same as CAS prepayment credits today. In most cases, such payments will not be recovered until many years in the future.

Third, the amortization period for actuarial gains and losses is shortened from 15 years to 10 years. While the period remains longer than the seven years used by the PPA, the ten-year period seems to be a compromise between accelerated cost recovery and significant cost volatility.

In general, these new provisions will result in significantly higher pension cost recovery than the current CAS rules. Although CAS will be revised in the direction of the PPA and FAS 158, the ANPRM does not share fully their same short-term approach. To the extent the ANPRM establishes a longer period for pension cost recovery, it is questionable whether the “harmonization” required by Section 106 of the PPA is achieved.

There is another problem in the ANRPM. It turns out that cost recovery is linked to a contractor's funding pattern, and this link involves the treatment of discretionary funding in
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excess of the PPA minimum required funding.

Specifically, contractors that limit funding of their pensions to only the PPA minimum will realize quicker cost recovery. When a contractor voluntarily contributes funds into its pension plan in excess of the amount required, those funds are classified as “credits” under the PPA (“voluntary prepayment credits” under CAS).

The PPA minimum funding calculations do not include a reduction for “credits.” The funding requirement is determined, and the contractor can choose whether to fund the amount with new contributions or to apply part of the credit amount. Should a contractor decide to apply a credit, the amount is then converted from discretionary funding to required funding. No such funding conversion is provided for in the ANPRM, despite the introduction of new concepts such as “voluntary prepayment” and “mandatory prepayment,” with mandatory prepayments amortized over five years in addition to costs. Although earlier cost recovery for some contractors may be an unintended consequence, the inequitable result conflicts with rules whose purpose is consistency in application.

This problem is exacerbated by the CAS definition of the “minimum required funding,” which includes a reduction for the PPA credits. A contractor that does not apply its credits for the PPA, and instead funds the PPA requirement with new contributions, will have to classify those new contributions as additional discretionary funding, which increases the voluntary prepayments.

This situation contrasts with a contractor that applies its PPA credits, and thereby resets the minimum required amount for CAS with zero credits. Such a contractor will be able to classify its contribution as a mandatory prepayment. In this manner, a contractor having no PPA funding reserve is rewarded under the ANPRM. Given the recent events in the market, and the effect on pension assets so close to the measurement date for determining funding required for the PPA, having a reserve to mitigate a significant cash need is a worthwhile goal the ANPRM ought not to discourage.

IV. Conclusion

The ANPRM demonstrates some CASB effort to move in the direction of faster cost recovery for contractors. However, it remains unclear how closely aligned CAS and the PPA must be to satisfy the PPA requirement for “harmonization.” Obviously, there are differences of opinion in ascertaining how much harmonization is enough to satisfy the PPA mandate. For example, if the revised CAS rules made pension costs equal in amount to PPA minimum funding, it would be extraordinarily difficult to develop accurate pricing for future years to bid CAS-covered contracts. This is because the pricing process would have to consider what the market conditions for valuing assets would be several years from now.

As current events have shown, estimating asset values so far into the future is
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speculative at best. A balanced approach by the CASB in developing these new rules may be the most desirable result, with equitable and reasonable cost recovery for contractors regardless of their funding patterns.

The good news is that once the final rule is published by the CASB (probably late in 2009), contractors will be entitled to equitable adjustments for this required change and will be able to price new contracts at rates consistent with the new CAS rules. The bad news is that recovery of the accumulated backlog of PPA minimum required funding amounts will begin in a staggered approach, with full cost recovery taking up to 12 years under the transition rules.

The good news is that once the final rule is published by the CASB (probably late in 2009), contractors will be entitled to equitable adjustments for this required change and will be able to price new contracts at rates consistent with the new CAS rules. The bad news is that recovery of the accumulated backlog of PPA minimum required funding amounts will begin in a staggered approach, with full cost recovery taking up to 12 years under the transition rules.

While the transition rules are lengthy, given the materiality of the increased costs and the bleak prospect of obtaining increased appropriations to fund those costs in the current economic environment, contractors may need to make the best of what's offered to avoid making a Hobson's choice between funding for their pension cost equitable adjustments or funding for their programs. However, unless litigation forces changes to DCAA's May 1, 2007, audit guidance or the new final rule is published and "harmonization" (such as it is) is complete, all but a few of the largest government contractors with defined benefit pension plans will continue to experience adverse impacts to their cash flows related to their CAS "prepayments."

As experienced contractors know, there is a dollar-for-dollar relationship between profit and unallowable costs. As long as government contractors cannot include the effects of the PPA to pension costs in their pricing, to that extent CAS-covered contracts will be less profitable.

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Endnotes

¹ - Pub. L. 109-280, 120 Stat. 780.

² - See "The Pension Protection Act of 2006: A Primer for Government Contractors and Grantees," by Peter A. McDonald, *BNA Federal Contracts Report*, Vol. 86, No. 10, September 19, 2006.

³ - "DCAA Audit Guidance Conflicts with the Pension Protection Act," by Peter A. McDonald, *BNA Federal Contracts Report*, Vol. 87, No. 21, May 29, 2007. Republished in *The Clause*, Boards of Contract Appeals Bar Association, Vol. XVII, No. 3, Summer 2007.

⁴ - 72 Fed. Reg. 127, pp. 36508-36511, July 3, 2007.

⁵ - *Ibid.*, p. 36509.

⁶ - *Ibid.*