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## FEATURE ARTICLE

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### Defining 'Increased Costs In The Aggregate'

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As the newly reconstituted Cost Accounting Standards Board begins to function, the Department of Defense likely will urge the board to take up the perennial and contentious issue of measuring the cost impact of changes in cost accounting practices, and, more particularly, that the board define "increased costs in the aggregate"—the last piece of unfinished business in DOD's long-running effort to rewrite the CAS and Federal Acquisition Regulation. Indeed, at the previous board's last meeting before losing its quorum, the staff urged the board to take up this very issue.

The minutes of the July 19, 2005 meeting indicate that the staff presented a paper to the board describing the opposing views of Government and contractor representatives on the interpretation of "increased costs in the aggregate" as used in the CAS Board's enabling statute. By "staff," the minutes presumably refer to David J. Capitano, Deputy Director, Defense Procurement and Acquisition Policy, who was—and still is—detailed to the CAS Board staff. Capitano also is the chairman of the Defense Acquisition Regulations Council and was the primary author of the FAR part 30 rewrite published March 9, 2005. According to

the minutes, staff pointed out that the final rule modifying part 30 did not specify how to calculate increased costs in the aggregate, since only the CAS Board has authority to define that term. The minutes state that the board instructed the staff to establish a working group to evaluate whether any revisions or interpretations to the board's rules and regulations are needed regarding the term "increased costs in the aggregate." As part of this effort, the board directed that the working group specifically consider how increased costs in the aggregate are computed when a contractor makes multiple accounting changes that take effect on the same date.

However, the problem is not the CAS Board's failure to define increased costs in the aggregate, but, rather, is the FAR Councils' unauthorized expansion of the definition of increased costs.

### Background

As with many thorny issues in Government contract cost accounting, the long-running dispute about how to measure the cost impact of changes in cost accounting practices began with the publication of DCAA audit guidance taking a position decidedly contrary to industry's view of the existing statutes and regulations. DCAA pressed its position and lost in the *Martin Marietta* case.<sup>1</sup> Shortly after the Armed Services Board of Contract Appeals issued its decision in that case, the CAS Board staff began what would prove to be an unsuccessful, seven-year effort to change the definition of a cost accounting practice change and redefine the cost impact process.

The rulemaking effort began with the publication in April 1993 of a staff discussion paper,<sup>2</sup>

and included an April 1995 advance notice of proposed rulemaking,<sup>3</sup> a September 1996 notice of proposed rulemaking,<sup>4</sup> a July 1997 supplemental notice of proposed rulemaking,<sup>5</sup> and an August 1999 second supplemental notice of proposed rulemaking<sup>6</sup> before the board essentially abandoned the effort. The final rule published in June 2000 made only modest changes to the CAS program requirements to clarify the applicable interest rate and describe the findings the administrative contracting officer must make before making any of the three types of adjustments contemplated by the various CAS clauses. The rule also added a new § 9903.20-8 to establish that contract price and cost adjustments do not apply to compliant cost accounting practice changes directly associated with external restructuring activities.<sup>7</sup> Soon after the final rule was published, DCAA issued audit guidance stating that a primary reason the final rule was “significantly reduced in scope as compared to earlier proposed rules” was that it had been “decided to include rules concerning CAS cost impact administration in the FAR.”<sup>8</sup>

In the meantime, the FAR Councils entered the fray with the April 2000 publication of proposed changes to FAR part 30.<sup>9</sup> The FAR Councils’ rulemaking proved almost as contentious and time-consuming as the CAS Board’s effort, and included a second proposed rule in July 2003<sup>10</sup> and four public meetings before the final rule was published in March 2005.<sup>11</sup> However, while two of the five CAS Board members are private-sector representatives, the FAR Councils have no such private-sector representation, and the FAR part 30 rewrite was published despite industry opposition. Nevertheless, the FAR part 30 rewrite stopped short of defining “increased costs in the aggregate.” DOD now has turned to the CAS Board to finish the job.

### The CAS Board’s Existing Interpretation of “Increased Costs”

The interpretation of “increased costs” at 48 CFR § 9903.306 initially was promulgated by the original CAS Board pursuant to the exclusive grant of authority contained in P.L. 91-379, and in 1992 was republished without change by the CAS

Board created under P.L. 100-679.<sup>12</sup> P.L. 91-379 authorized the original board to promulgate regulations that, inter alia, provide for “a contract price adjustment, with interest, for any increased costs paid to the defense contractor by the United States because of the defense contractor’s *failure to comply with duly promulgated cost-accounting standards or to follow consistently his disclosed cost-accounting practices* in pricing contract proposals and in accumulating and reporting contract performance cost data.”<sup>13</sup> Faithful to its statutory charge, in interpreting “increased costs,” the original board maintained the important distinction between contract adjustments required for *voluntary changes* and those required for CAS *noncompliances and failures to follow disclosed practices*.

This distinction is apparent in the board’s interpretation of increased costs. Paragraph (a) of the interpretation applies to both accounting practice changes and noncompliances, and defines “increased costs” as the actual costs paid by the Government as a result of the change or noncompliance. It provides:

Increased costs shall be deemed to have resulted whenever the cost paid by the Government results from a *change in a contractor’s cost accounting practices* or from a failure to comply with applicable Cost Accounting Standards, and such cost is higher than it would have been had the practices not been changed or applicable Cost Accounting Standards been complied with.<sup>14</sup>

For a firm-fixed-price contract, a change in cost accounting practice does not result in any change in the cost paid by the Government because the price of an FFP contract remains the same regardless of the contractor’s actual cost experience. Accordingly, under paragraph (a) of the interpretation, decreased cost allocations to a FFP contract do not constitute increased costs.

Paragraph (b), on the other hand, applies *only* to CAS noncompliances and failures to follow disclosed and established cost accounting practices. Because it serves to discourage such improprieties, paragraph (b) uses a more punitive measure of “increased costs” that pierces the sanctity of a firm-fixed price to reach constructively increased costs, i.e., the cost paid by the Government does

not change, but the contractor stands to earn a greater profit because of the change. It provides:

If the contractor under any fixed-price contract, including a firm fixed-price contract, fails during contract performance to follow his cost accounting practices or to comply with applicable Cost Accounting Standards, increased costs are measured by the difference between the contract price agreed to and the contract price that would have been agreed to had the contractor proposed in accordance with the cost accounting practices used during contract performance. The determination of the contract price that would have been agreed to will be left to the contracting parties and will depend on the circumstances of each case.<sup>15</sup>

In originally promulgating this interpretation of increased costs, the CAS Board recognized that the result was harsh and was opposed by “a majority of the industry commentators who maintain[ed] that under FFP contracts once price is agreed to, there can be no increased cost paid by the U.S. attributed to any subsequent changes the contractor may make in its cost accounting practices.”<sup>16</sup> Nevertheless, the board included paragraph (b) to address congressional concerns regarding CAS noncompliances and failures to follow disclosed or established accounting practices. Regarding paragraph (b), the preamble to the original publication of the interpretation states:

This provision prescribes price adjustments for all contracts *where there is a failure to comply in pricing proposals and in accumulating and reporting costs*. Since the Congress did not exclude FFP contracts when it provided for recovery of increased cost paid to the contractor because of a failure to comply or failure to follow, it was and still is incumbent on the Board to insure that, in the absence of an exemption, such recovery is accomplished.<sup>17</sup>

The CAS clause likewise contemplates distinct types of contract adjustments for cost accounting practice changes and CAS noncompliances. For noncompliances, the clause expressly contemplates a price adjustment and mandates the recovery of increased costs paid by the U.S. Specifically, subparagraph (a)(5) requires the contractor to agree to “an adjustment of the contract price or cost allowance ... if the Contractor or a subcontractor

fails to comply with an applicable Cost Accounting Standard, or to follow any cost accounting practice consistently ....”<sup>18</sup> It also expressly stipulates that the “adjustment shall provide for recovery of the increased costs to the United States ....”<sup>19</sup>

By contrast, subparagraph (a)(4)(ii), which applies to cost accounting practice changes, requires only that the contractor “negotiate with the Contracting Officer to determine the terms and conditions under which a change may be made to a cost accounting practice,” with the proviso that “no agreement may be made under this provision that will increase costs paid by the United States.”<sup>20</sup> Accordingly, for accounting practice changes, the clause does not require a price adjustment, nor for that matter, any particular type of adjustment. Moreover, there is no requirement under subparagraph (a)(4)(ii), as there is under subparagraph (a)(5), for “*recovery* of increased costs paid by the United States.”<sup>21</sup> The discretionary nature of the agreement contemplated by subparagraph (a)(4)(ii) is supported by the existing interpretation at CAS 9903.306(d), which provides:

The contractor and the contracting officer *may* enter into an agreement as contemplated by paragraph (a)(4)(ii) of the Cost Accounting Standards clause at § 9903.201-4(a), covering a change in practice proposed by the Government or the contractor for all of the contractor’s contracts for which the contracting officer is responsible, provided that the agreement does not permit any increase in the cost paid by the Government.<sup>22</sup>

The CAS also make clear that a cost accounting practice change differs significantly from either a noncompliance or failure to follow consistently the contractor’s pre-change, disclosed or established practices. CAS 401 is the standard that would be implicated by a failure to follow consistently a contractor’s disclosed or established cost accounting practices. In applying the fundamental requirements of CAS 401, the standard makes two important points. First, compliance with CAS 401-40(a) is determined as of the date of contract award or, if the contractor submits cost or pricing data, the date of final agreement on price.<sup>23</sup> Second, a contractor may change its accounting practices without violating CAS 401. CAS 401-50(b) provides, “Notwithstanding 9904.401-40(b), changes

in established cost accounting practices during contract performance may be made in accordance with part 99.”<sup>24</sup> This provision was added during the initial promulgation of CAS 401 to address the seeming “inconsistency between the requirements of the standard and the ability to make changes to established cost accounting practices.”<sup>25</sup> As the original board explained at the time:

The Board intends that compliance with respect to proposals shall be determined as of the award date of the contract or as of the date of final agreement on price if the contractor has submitted cost or pricing data pursuant to Pub. L. 87-653 [Truth in Negotiations Act]. Modifications of established cost accounting practices for accumulating and reporting costs are permitted by other regulations of the Cost Accounting Standards Board without causing a violation of this standard. The Board has modified the standard to express these intentions.<sup>26</sup>

The statutory language underlying the original interpretation of increased costs changed with enactment of the 1988 amendments to the Office of Federal Procurement Policy Act. P.L. 100-679 directs the CAS Board to promulgate rules and regulations to be incorporated in the FAR for the implementation of CAS promulgated or interpreted under the board’s statutory authority.<sup>27</sup> Among other things, these regulations must require contractors and subcontractors to “agree to a contract price adjustment, with interest, for any increased costs paid to such contractor or subcontractor by the United States by reason of a *change in the contractor’s or subcontractor’s cost accounting practices* or by reason of a failure by the contractor or subcontractor to comply with applicable cost accounting standards.”<sup>28</sup> Therefore, in contrast to P.L. 91-379, P.L. 100-679 authorizes the board to promulgate regulations requiring the recovery of increased costs paid as a result of both CAS noncompliances and changes in cost accounting practice. Importantly, however, the statute goes on to provide that:

Any contract price adjustment undertaken pursuant to paragraph (1)(B) shall be made, where applicable, on relevant contracts between the United States and the contractor that are subject to the cost accounting standards so as to protect the United States from

payment, in the aggregate, of increased costs (as defined by the Board). In no case shall the Government recover costs greater than the increased cost (as defined by the Board) to the Government, in the aggregate, on the relevant contracts subject to the price adjustment, unless the contractor made a change in its cost accounting practices of which it was aware or should have been aware at the time of the price negotiation and which it failed to disclose to the Government.<sup>29</sup>

The legislative history of the 1988 amendments confirms that this change in the statutory language was deliberate. As Senate Report No. 100-424 explains:

An issue brought to the Committee’s attention by industry is that the application of a CAS Board interpretation regarding the effect of contractor initiated changes in accounting systems may result in an inequity to the government or the contractor, when such accounting changes have the effect of reducing costs allocated to firm fixed-price contracts. While the Committee does not express any view on the merits of this issue, it fully anticipates the new CAS Board will analyze the circumstances under which such reduced cost allocations may or may not give rise to possible fiscal damage to the government and make any changes in existing rules or interpretations deemed appropriate as a result of the analysis.<sup>30</sup>

Thus, while giving the CAS Board the statutory authority to treat decreased costs on FFP contracts as increased costs to the Government, when a contractor makes a change in its cost accounting practices, as well as when the contractor fails to comply with an applicable Standard or its disclosed practices, Congress expressly took no position on whether such a change in the regulatory interpretation was appropriate. However, Congress clearly intended for the CAS Board—and not the FAR Councils—to define increased costs and, in doing so, to “analyze the circumstances under which such reduced cost allocations [to FFP contracts] may or may not give rise to possible fiscal damage to the government and to make any change in existing rules or interpretations deemed appropriate as a result of the analysis.”<sup>31</sup> Moreover, P.L. 100-679 expressly prohibits either the CAS Board or the

FAR Councils from requiring a contract price adjustment that results in recovery of more than the increased costs in the aggregate, as defined by the CAS Board.

### **FAR Part 30 Rewrite and DOD's Unfinished Business**

While stopping short of defining “increased costs in the aggregate,” the FAR Councils, in revising FAR part 30, nevertheless significantly changed the definition of increased costs. FAR 30.604 as revised effectively applies the 48 CFR 9903.306 paragraph (b) interpretation to cost accounting practice changes. In particular, FAR 30.604(h)(3)(ii)(A) states that, for unilateral changes, when the estimated cost to complete using the changed practice is less than the estimated cost to complete using the current practice, the difference is increased cost to the Government. The Councils' comments accompanying publication of the final rule provided the following rationale for this change.

*Comment:* Six respondents commented that firm-fixed-price (FFP) contracts should not be included in the cost-impacts for changes in cost accounting practices. One respondent asserted that “increased costs to the Government only result from a change in contractor's cost accounting practices when the actual costs paid by the Government are more than they would have been had the contractor's practices not changed.” The respondent further asserted that FFP contracts are not included in the cost-impact because the amount of costs a contractor assigns to FFP contracts due to a change in cost accounting practices has no effect on the amount ultimately paid by the Government.

*Councils' response:* Nonconcur. FFP contracts are properly included in cost-impacts for changes in cost accounting practice in the subject rule. 48 CFR 9903.306(a) does not differentiate among contract types in its definition of increased costs to the Government. Further, 48 CFR 9903.306(b) measures increased costs for FFP contracts by “the difference between the contract price that would have been agreed to had the contractor proposed in accordance with the cost accounting practices used during contract performance.” The final rule at FAR 30.604 is consistent with the requirements at 48 CFR 9903.306(a) and (b).<sup>32</sup>

Because this is precisely what Congress expected the CAS Board to analyze before making whatever changes to existing rules and interpretations the CAS Board deemed appropriate, and because only the CAS Board has authority to define “increased costs,” FAR 30.604 may well exceed the FAR Councils' statutory authority.

Despite having expanded the definition of increased costs, the FAR Councils withdrew a proposed calculation of increased costs in the aggregate, apparently agreeing with public comments that the proposal “was a violation of CAS and the statutory provision.”<sup>33</sup> By withdrawing the calculation, the FAR Councils eliminated a proposed prohibition on making offsets between contract types. The comments accompanying the final rule state:

*Comment:* Two respondents stated that the proposed rule incorrectly disallows offsets between contract types. In addition, one respondent asserted that the Government could be provided with a “windfall profit” if offsets are not allowed between contract types in the case of any noncompliance or unilateral change that causes costs to shift between fixed-price contracts and subcontracts and flexibly-priced contracts and subcontracts.

*Councils' response:* The comment is no longer applicable—the final rule does not include the calculation of increased cost in the aggregate. The calculations were removed from the final rule (see comment 26).<sup>34</sup>

Put another way, the FAR Councils did not eliminate the prohibition on offsets between contract types because they agreed the prohibition was wrong; they eliminated it because they believed it was part of defining increased costs in the aggregate. Thus, one should not be surprised to see the same prohibition appear in some future CAS Board staff discussion paper.

### **Measuring Fiscal Damage to the Government**

In directing the CAS Board to define increased costs, Congress demonstrated its intent that the board analyze possible fiscal damage to the Government and then make whatever changes in the existing rules and interpretations that the board

deemed necessary. Applying this analysis, decreased costs allocations on FFP contracts cannot be construed as increased costs because they do not give rise to any fiscal damage to the Government. To illustrate, assume that a contractor has two \$10 million CAS-covered contracts, one FFP and one cost reimbursement, each requiring the contractor to deliver 100 production units. The Government is therefore buying 200 units for \$20 million. Assume further that the contractor makes a change in its cost accounting practices that shifts costs totaling \$100,000 from the FFP contract to the cost reimbursement contract. If the Government pays \$10 million on the FFP price contract and reimburses costs of \$10.1 million on the cost reimbursement contract, most observers would agree that the Government paid increased costs of \$100,000. Put another way, the Government is still buying 200 units, but is now paying \$20.1 million instead of \$20 million for them.

Now assume that the contractor has only one CAS-covered contract—the FFP contract—and its other contract is with a commercial customer. As before, the cost accounting practice change shifts \$100,000 of costs from the FFP contract to the commercial contract. This time, however, the change does not result in any increased costs because the Government still gets precisely the same number of units for the same price as it was before the change.

But suppose one objects that the contractor has increased its profit on the FFP contract, and had the Government known the contractor was going to make the change, the Government would have negotiated a lower price. The statute itself responds to that objection by providing an exception to the rule that the Government cannot recover more than increased costs in the aggregate. Importantly, however, the exception applies only when the contractor knew or should have known of the change at the time of negotiation and failed to disclose the anticipated change to the Government. The statute effectively treats this circumstance as a form of defective pricing. It provides, “In no case shall the Government recover costs greater than the increased costs (as defined by the Board) to the Government, in the aggregate, on the relevant contracts subject to the

price adjustment, unless the contractor made a change in its cost accounting practices of which it was aware or should have been aware at the time of price negotiation and which it failed to disclose to the government.”<sup>35</sup> Nevertheless, FAR 30.604(h)(3)(ii)(A) treats decreased costs on a FFP contract as increased costs regardless of whether the contractor was aware of the change at the time of price negotiation and failed to disclose it to the Government. As a consequence, FAR 30.604 defines increased costs so broadly as to render the statutory exception meaningless.

FAR part 30’s proscription against combining multiple cost accounting practice changes is similarly inconsistent with the CAS statute. Prior to the March 2005 amendments, FAR part 30 did not address which cost impacts could and could not be combined. It is a long-accepted practice that contractors combine the cost impact of all accounting practice changes taking effect at the same time. As revised, FAR 30.606(a)(3)(ii)(A) specifically prohibits combining the cost impact of multiple unilateral changes, unless all have increased costs.

Nothing in P.L. 100-679 supports, much less requires, treating separately the cost impact of individual cost accounting practice changes that take effect at the same time. As noted above, the statute requires the CAS Board to promulgate regulations requiring contractors and subcontractors to “agree to a contract price adjustment, for any increased costs paid to such contractor or subcontractor by the United States by reason of a change in the contractor’s or subcontractor’s cost accounting practices ....”<sup>36</sup> A change in cost accounting practices may and frequently does include multiple components. For example, a contractor combines two segments, segment A and segment B. Before the change, segment A allocated general and administrative expenses using a total cost input base and allocated manufacturing overhead using a direct labor hours base. On the other hand, segment B allocated G&A expenses using a value-added base and allocated manufacturing overhead using a direct labor dollars base. After the segments are combined, segment B adopts segment A’s cost accounting practices. Accordingly, from segment B’s perspec-

tive there is a single change to its cost accounting practices affecting the allocation of both G&A expenses and manufacturing overhead. Assume that the change in G&A allocation results in a lesser allocation of costs to FFP contracts and a greater allocation to flexibly priced contracts; whereas the change in manufacturing overhead allocation results in a greater allocation of costs to FFP contracts and a lesser allocation to flexibly priced contracts. Not allowing the contractor to combine these changes would result in a recovery of more than the monetary damage to the U.S., and, thus, an unlawful recovery of more than the increased costs in the aggregate paid by the U.S. More fundamentally, the FAR proscription begins from two premature—and currently erroneous—premises, namely, that unilateral changes require the recovery of increased costs paid and that decreased costs on a FFP contract represent increased costs to the Government. Unless and until the CAS Board revises its existing regulations and interpretations, both premises are wrong. Thus, the problems presented to the CAS Board are problems of the FAR Councils' making.

## Conclusion

Notwithstanding the issue's presentation by the previous board's staff, the CAS Board has the exclusive statutory authority to define increased costs and increased costs in the aggregate. The FAR part 30 rewrite trenched on the CAS Board's authority by expanding the definition of increased costs. As for the specific issues the previous board directed its staff to examine, combining multiple changes in cost accounting practice that take effect at the same time was never an issue before the March 2005 revision to FAR part 30, and, in the absence of that revision, would not be a problem now. Thus, the CAS Board should take up the issue of increased costs in the aggregate, but rather than acceding to DOD's desire to conform the CAS rules and interpretations to FAR part 30, the CAS Board should reassert its statutory primacy and reaffirm its existing interpretation of increased costs. The board should also ask its chairman, in his position as OFPP Administrator, to strike down the offending provisions of FAR part 30.

## ❖ Endnotes

- 1 *Martin Marietta Corp.*, 92-3 BCA ¶ 25,175, *aff'd sub nom.*, *Perry v. Martin Marietta Corp.*, 47 F.3d 1134 (Fed. Cir. 1995).
- 2 See 58 Fed. Reg. 18428 (April 9, 1993); 35 GC ¶ 256.
- 3 See 60 Fed. Reg. 20252 (April 25, 1995); 37 GC ¶ 236.
- 4 See 61 Fed. Reg. 49196 (Sept. 18, 1996); 38 GC ¶ 451.
- 5 See 62 Fed. Reg. 37654 (July 14, 1997); 39 GC ¶ 344.
- 6 See 64 Fed. Reg. 45700 (Aug. 20, 1999); 41 GC ¶ 392; 41 GC ¶ 402.
- 7 See 65 Fed. Reg. 37470 (June 14, 2000); 42 GC ¶ 247.
- 8 See DCAA Memorandum for Regional Directors 00-PAC-071 (R), "Audit Guidance on Recent Cost Accounting Standards (CAS) Rules" (Aug. 11, 2000).
- 9 See 65 Fed. Reg. 20854 (April 18, 2000); 42 GC ¶ 157.
- 10 See 68 Fed. Reg. 40104 (July 3, 2003); 45 GC ¶ 272.
- 11 See 70 Fed. Reg. 11743 (March 9, 2005).
- 12 Compare 48 CFR § 9903.306(a), (b) (Jun. 18, 1992) with 4 CFR § 331.70(a), (b) (Jan. 1, 1986) (virtually verbatim provisions, except for the numbering).
- 13 P.L. 91-379, 84 Stat. 796 (Aug. 15, 1970) (codified at 50 USCA App. 2168(h)(1)) (emphasis added).
- 14 48 CFR § 9903.306(a) (emphasis added).
- 15 48 CFR § 9903.306(b) (emphasis added).
- 16 Preamble to Revision and Republication of Part 331, 45 Fed. Reg. 62009 (Sept. 18, 1980) (emphasis added).
- 17 *Id.* (emphasis added).
- 18 48 CFR § 9903.201-4(a)(5).
- 19 *Id.*
- 20 48 CFR § 9903.201-4(a)(4)(ii).
- 21 48 CFR § 9903.201-4(a)(5) (emphasis added).
- 22 48 CFR § 9903.306(d) (emphasis added).
- 23 48 CFR § 9904.401-50(b).
- 24 *Id.*
- 25 Preamble A to CAS 401, Preamble 37 Fed. Reg. 4139 (Feb. 29, 1972).
- 26 *Id.*
- 27 P.L. 100-679 § 26(g)(1)(B), 102 Stat. 4059 (Nov. 17, 1988), codified at 41 USCA § 422(h)(1).
- 28 41 USCA § 422(h)(1)(B) (emphasis added).
- 29 41 USCA § 422(h)(3).
- 30 S. Rep. No. 100-424, 100th Cong. 2d Sess. 17, reprinted in 1988 U.S.C.C.A.N. 5687, 5703 (Nov. 17, 1988).
- 31 S. Rep. No. 100-424, 100th Cong. 2d Sess. 17, reprinted in 1988 U.S.C.C.A.N. 5687, 5703 (Nov. 17, 1988) (emphasis added).
- 32 70 Fed. Reg. 11743, 11746 (March 9, 2005).
- 33 *Id.* at 11747.
- 34 *Id.* at 11748.
- 35 P.L. 100-679 § 26(h)(3), 102 Stat. 4059 (Nov. 17, 1988) (emphasis added).
- 36 41 USCA § 422(h)(1)(B).