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The Allocability of IR&D -- A Fork in the Road?

With the elimination of the IR&D and B&P ceiling a decade or so ago and the recognition of "dual use" technologies as appropriate subjects of IR&D, contractors have tended to place questions relating to the allocability of IR&D on the back burner. True, the old concurrency issue remained, but allocability seemed to be relatively non-controversial. Based upon a COFC decision issued earlier this year -- and to quote Bob Dylan -- "The times they are a changin.'"

In *Teknowledge Corp. v. United States*, 85 Fed.Cl. 235 (Fed. Cl. 2009), the COFC held that the cost of development of its TekPortal software program was not allocable to Government contracts even though (a) the contractor had originally developed the software with the intent to use it as a "dual use" asset in connection with its Government and commercial businesses, (b) had proposed its use in three unsuccessful responses to Government solicitations, and (c) the commercial contracts on which it had been used since development had sufficiently expanded the contractor's business to absorb some $3,000,000 in G&A that otherwise would have been allocated to the company's Government contracts. Citing to the Federal Circuit's decision in *Boeing N. Am., Inc. v. Roche*, 298 F.3d 1274, 1281 (Fed. Cir. 2002), the COFC held that the above-described facts were insufficient to establish the requisite "nexus" between the challenged cost and a Government contract to support allocability.

Working its way through FAR 31.201-4, the court held, first, that the costs were not allocable under FAR 31.201-4(b) as costs that benefit the contract and other work because there was no underlying Government contract that benefited from the costs. Noting that the Government "has never purchased TekPortal," the court accepted the Government's argument that "benefit" in the context of FAR 31.201-4(b) cannot be "some vague, prospective potential benefit to the Government," which in this case was twofold: the potential utility of the software on future Government contracts and the $3,000,000 in G&A absorption that otherwise would have visited itself on the Government contracts that Teknowledge did have in-house. This finding seems curious -- the company had existing Government contracts and they appear to have benefited in a concrete and objectively verifiable monetary fashion.

Interestingly, the Claims Court had previously held in *KMS Fusion, Inc. v. United States*, 24 Cl. Ct. 582 (1991) that the costs of "government affairs consultants" were allocable to Government contracts in part because a DOE contract had "benefited in a specific sense by seeing a reduction of indirect costs allocated to the contract where marketing efforts succeeded in bringing in additional business for the company." *Teknowledge*, 85 Fed. Cl. at 240. The court seemed to find

no inconsistency between the results in *Teknowledge* and *KMS Fusion*. That conclusion seems strained -- the benefits were identical, *i.e.*, in *Teknowledge* other Government contracts "benefitted in a specific sense by seeing a reduction of indirect costs allocated" to those contracts. In both cases the incurrence of the costs in question resulted in reduced allocations of indirect costs to one or more Government contracts from an expansion of general sales.

The court's analysis under FAR 31.201-4(b) does not bode well for Government contractors. IR&D ought not need to succeed in the actual delivery of a Government contract in order for it to benefit the Government or any individual Government contract. If that is the rule, IR&D becomes a literal game of chance in which downstream, after-the-fact success becomes determinative of allocability. This can most assuredly have a chilling effect on the willingness of companies to invest in "dual use" technologies for which success in the Government marketplace is less than assured.

Turning to FAR 31.201-4(c) -- allocability based on the necessity of the costs to the overall operation of the business -- the court held that "even under the third prong of the allocability test, the contractor must show some nexus to a government contract." While this is true under the language of *Boeing North American*, it finds no expression in FAR 31.201-4(c), which is completely silent as to the benefits of the cost to any given contract and, to the contrary, merely requires a showing that the cost "[i]s necessary to the business, although a direct relationship to any particular cost objective cannot be shown." The only test articulated in the regulation, thus, is one of business necessity. With respect to that issue, the court found an evidentiary failure in that no evidence was offered "explaining how TekPortal keeps Teknowledge afloat." *Teknowledge*, 85 Fed. Cl. at 241.

Where *Teknowledge* takes us ultimately is an open question. Where it takes DCAA is more clear -- into a fresh new inquiry with respect to the "benefit" of IR&D projects that have not yielded products used or produced in the performance of Government contracts.

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