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Proposed Rule For Independent Research & Development ("IR&D") Costs Raises Concerns

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On November 4, 2016, the Department of Defense ("DOD") issued a proposed rule that would amend the Defense Federal Acquisition Regulation Supplement ("DFARS") to require DOD Contracting Officers to adjust offerors' proposed prices and estimated costs upward when their proposals rely on the results of their IR&D efforts. The proposed rule, which would apply only to major defense acquisition programs and major automated information systems in a development phase, includes a new solicitation provision with potentially ambiguous wording that could cause problems for contractors if it is not clarified.

The proposed new solicitation provision states in part, "If the Offeror, *in the performance of any contract* resulting from this solicitation intends to use IR&D *to meet the contract requirements*, the Offeror shall include documentation in its proposal to support this approach." (emphasis added). The proposed rule does not define any of the terms in this provision. In view of the case law interpreting the definition of IR&D costs, the phrases "in the performance of any contract" and "to meet contract requirements" may create confusion.

The cost principle at Federal Acquisition Regulation ("FAR") 31.205-18 governs the allowability of IR&D costs. This principle permits contractors to recover the cost of IR&D efforts as indirect costs allocated to their government contracts. But this rule excludes from IR&D costs "the costs of [research or development] effort sponsored by a grant or required in the performance of a contract." Cost Accounting Standards ("CAS") section 420–30(a)(6) contains the same exclusion when addressing whether a cost is allocable to a particular contract. Courts and boards have struggled to interpret the meaning of the phrase "required in performance of a contract" within the context of this exclusion with the Government consistently advocating that effort that is implicitly necessary to perform a contract cannot be treated as IR&D. In other words, the Government has argued that if the contract cannot be performed successfully but for performance of the

tasks in question, the costs related to these tasks are ineligible to be treated as IR&D. See, e.g. *U.S. v. Newport News Shipbuilding, Inc*., 276 F.Supp. 2d 539, 561-62 (E.D. Va. 2003) and *U.S. ex rel Mayman v. Martin Marrietta Corp*, 894 F.Supp. 218, 221 (D.Md. 1995).

In 2010, however, the Federal Circuit rejected the Government's interpretation of the phrase "required in the performance of a contract." In *ATK Thiokol, Inc. v. United States*, 598 F.3d 1329, 1335 (2010), the Federal Circuit found that research and development implicitly necessary to perform a contract *could be* charged as indirect IR&D costs. The court held that the exclusion applied only to costs that are specifically required by the contract. To reach this conclusion, the court relied on case law (*Boeing Co. v. U.S*., 862 F.2d 290, 292-93 (Fed. Cir. 1988)) interpreting the identical phrase in the definition of "bid and proposal costs." 598 F.3d at 1334-1335 (interpreting FAR 31.205–18(a) and CAS 420–30(a)(2)). *ATK Thiokol* involved a contract between ATK and a commercial customer in which the customer agreed to pay the cost required to adapt and attach ATK's motors to Japanese government launch vehicles, but refused to pay the ongoing costs for development and upgrade of the motors which had been underway for several years. ATK accounted for these general development and upgrade costs as indirect IR&D costs. The Government disallowed those costs on the theory that ATK had to incur them to deliver the motors required under the commercial contract. The Government relied heavily on the *Newport News* decision. The Federal Circuit was unpersuaded, and relying on its earlier *Boeing* decision, and CAS 402-61(c) (for bid and proposal costs), held that only costs that are "specifically required by the provisions of a contract," are excluded from the IR&D cost principle's coverage. 598 F.3d at 1335.

In light of the holding in the *ATK Thiokol* case, the proposed rule's reference to "IR&D to meet the contract requirements" is confusing and ambiguous. If the proposed rule means research and development that is "specifically required by the contract," then by definition, such costs cannot be treated as IR&D. FAR 31.205-18 excludes those costs from the definition of IR&D costs. The absence of such clarifying wording, however, makes it unclear whether the proposed rule's wording intends to address only research and development effort implicitly necessary to perform the contract. If so, in the absence of clarifying wording in any future promulgation of this rule, contractors should be careful to make clear in their proposals that they intend to utilize the fruits of IR&D effort, that any ensuing contract does not require the IR&D effort to be performed as part of the contract's statement of work and that the contract does not intend to pay for that IR&D effort.

Obviously, these considerations have serious implications for the ownership of data rights issues as well.

If you have any questions about the content of this Alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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