Government Contracts Advisory

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Proposed DFARS Rule Seeks To Add Allowability Criteria For Independent Research And Development Costs

Yesterday, March 2, 2011, the Defense Acquisition Regulation System published a **proposed rule** to amend the Department of Defense Federal Acquisition Regulation Supplement (DFARS) provision relating to the allowability of Independent Research and Development (IR&D) costs. *See* 48 C.F.R. § 231.205-18. The proposed rule, if implemented, would require that major contractors carefully assess their existing procedures for delineating IR&D projects and adjust those procedures to ensure clear reporting on the nature of their independent research efforts and why those efforts are of interest to the Department of Defense (DOD).

The proposed rule would require contractors to report their IR&D projects generating annual costs in excess of $50,000 by adding the following provision to DFARS § 231.205-18(c)(iii):

> (C) For a contractor's annual IR&D costs in excess of $50,000 to be allowable, the IR&D projects generating the costs must be reported to the Defense Technical Information Center (DTIC) using the DTIC's on-line input form and instructions. The inputs must be updated at least annually and when the project is completed. Copies of the input and updates must be made available for review by the cognizant Defense Contract contracting officer (ACO) and the cognizant Defense Contract Audit Agency auditor to support the allowability of the costs.

The stated rationale for this proposed change is to rectify "a loss of linkage between funding and technological purposes" of the IR&D effort to ensure the effort meets DOD interests and needs. According to the rule's drafters, "[w]ithout the collection of this information, DOD will be unable to maximize the value of the IR&D funds the Department disburses without infringing on the independence of contractors to choose which technologies to pursue in IR&D programs." *See* 76 Fed. Reg. 11414.

The proposed rule presents a new compliance requirement that contractor's must be prepared to address. It appears that the rule applies solely to major contractors because the proposed subsection to which the new provision would be added, subsection 231.205-18 (c)(iii), currently establishes additional limitations on allowability that are applicable solely to major contractors. Because the new provision is added thereunder, it appears this new allowability requirement is only applicable to major contractors.

Under the same DFARS provision, "major contractors" are defined as: "any contractor whose covered segments allocated a total of

more than $11,000,000 in IR&D/B&P costs to covered contracts during the preceding fiscal year…" DFARS § 231.205-18(a)(iii). Additionally, the section defines a "covered contract" to be a DOD prime or subcontract exceeding the simplified acquisition threshold. DFARS § 231.205-18(a)(i). Importantly, fixed price contracts or fixed price subcontracts under fixed price prime contracts are not "covered contracts." *Id.*

Despite indications that this rule only applies to major contractors, this is an issue that should be clarified by the rule's drafters. Until there is a clarification on which contractors are obligated to report on IR&D projects over $50,000, the prudent course will be to establish procedures for handling this new reporting requirement should the rule be adopted.

In addition to the foregoing, the rule, as drafted, leaves a number of unanswered questions, including:

- The nature of the information that must be provided through the proposed DTIC on-line input form and the means of transmission are not addressed in the rule. The proposed rule does not include a copy of the proposed form or the instructions;

- Supplying information by means of an on-line form is problematic, particularly if the form does not contain clear means for the contractor to control dissemination of the information, if there are limits on the amount of space provided for information to be inserted, or (most importantly) if the data transmission is not encrypted using HTTPS or some other secure means of data transfer; and

- It appears DOD, through ACOs and DCAA, will use this information to assess not only what IR&D effort is of interest to DOD, but also to assess whether the effort is actually required in the performance of a contract. Accordingly, contractors must carefully manage how their projects are described to ensure the information is accurate and properly reflects the independent nature of the undertaking.

The IR&D projects pursued by contractors are often cutting edge and state of the art, involving information that is treated in strictest confidence and secrecy by contractors. Providing detailed information regarding such projects through an on-line form arguably fails to properly balance the stated interest of the government against contractors' concerns for the confidentiality of valuable proprietary information.

Should the rule be adopted, and even if it is not, MLA recommends that contractors who incur or may incur IR&D costs:

1. Carefully consider the terms of their disclosed accounting practices to ensure that they have clearly articulated the criteria they will use to classify costs as direct or indirect, a consideration made particularly relevant by the Federal Circuits decision in the *ATK Thiokol* decision;

2. Ensure that contract terms, both government and commercial, are drafted in a manner that clearly establishes the parties' intent regarding any research effort being undertaken so as to ensure that the contract clearly identifies whether an R&D effort is, or is not, specifically required by the contract;

3. Establish a clear process for the careful delineation of IR&D

effort from other contract related research and development effort; and

4. If an IR&D project is being considered, clearly document the benefits of that project to government and its alignment with the stated interest of DOD to best ensure the costs will be properly determined allowable by the ACO with assistance from DCAA.

These and other issues may be addressed in public comments, which must be submitted before May 2, 2011. It is anticipated that the American Bar Association Public Contract Law Section, Cost and Pricing Committee will submit comments on this proposed rule. Additionally, other industry organizations will likely also submit comments. MLA will circulate additional alerts as information on this proposed rule becomes available.