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FEDERAL CIRCUIT AFFIRMS DECISION ON INDEPENDENT RESEARCH AND DEVELOPMENT, FAVORABLE TO GOVERNMENT CONTRACTORS

On March 19, 2010, the United States Court of Appeals for the Federal Circuit issued its long-awaited decision on the controversial subject of allowable Independent Research and Development (IR&D) costs. *ATK Thiokol, Inc.* v. *United States*, doc. no. 2009-5036 (Fed. Cir. March 19, 2010). The Federal Circuit affirmed the decision of the Court of Federal Claims (COFC) that the language "required in the performance of a contract" in Federal Acquisition Regulation (FAR) 31.205-18(a) (defining IR&D) means "specifically required by the provisions of a contract." Thus, the Federal Circuit has rejected the government's position that the regulatory exclusion that IR&D "does not include the costs of effort sponsored by a grant or required in the performance of a contract" should encompass any effort implicitly required to perform the contract, whether or not such effort is an express contract term. In so doing, the Federal Circuit rejected the decision of *United States* v. *Newport News Shipbuilding, Inc.*, 276 F.Supp. 2d 539 (E.D. Va. 2003).

Briefly, ATK engaged in a development effort to upgrade its Castor IVA-XL motor in the mid 1990s. In 1996, Mitsubishi expressed an interest in purchasing modified Castor IVA-XL motors and the parties executed a contract in 1997. ATK charged the Castor IVA-XL development costs as IR&D—an indirect cost allocated to all contracts, including government contracts. The government asserted that the costs were direct costs of the Mitsubishi contract, because the development was an implicit requirement to perform the Mitsubishi contract.

FAR 31.205-18, governing the allowability of IR&D costs, provides in part that IR&D "does not include the costs of effort sponsored by a grant or required in the performance of a contract." Thus, if a cost is required in the performance of a contract, it would not be IR&D, an indirect cost, and would be allocated directly to a contract. Contractors have taken the position that "required in the performance of a contract" should be read narrowly to include only explicit contract requirements, while the government has taken the position that it should be read broadly to include implicit requirements.

The COFC held that whether a "cost is 'required in the performance of a contract' is controlled by the contracting parties' intent, as determined by traditional

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contract interpretation on a case-by-case basis." *ATK Thiokol* v. *United States*, 68 Fed. Cl. 612 (2005). The COFC, therefore, looked to the express terms of the contract. The COFC also considered the nature of an indirect cost, particularly as set out in Cost Accounting Standard (CAS) 402, noting that the distinguishing element of whether a cost is direct or indirect is whether the cost "is identifiable specifically with a particular final cost objective," a "specific requirement in an existing contract." Finding that ATK had treated the IR&D costs as indirect, consistent with its CAS disclosure statement and that the general improvements of the motor were not part of the Mitsubishi contract pricing structure, the COFC concluded that the costs were properly indirect IR&D. In so holding, the COFC rejected the government's theory that an implicit effort qualifies as "in the performance of a contract."

In affirming the COFC, the Federal Circuit relied on the identical language appearing in the definition of Bid and Proposal (B&P) costs in FAR 31.205-18, and specifically Interpretation No. 1 to CAS 402 involving B&P costs. The Federal Circuit found that

> Interpretation No. 1 distinguishes proposal costs that are "specifically required by" an existing contract from those that "do not result from such specific requirements." The former costs "relate only to [a particular] contract," while the latter costs "relate to all work of the contractor" and thus qualify as B&P. The effect of Interpretation No. 1 is to equate the B&P definitional exclusion of proposal costs that are "required in the performance of a contract" with the category of costs that are "specifically required by the provisions of a contract."
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> The same analysis applies to the closely analogous category of IR&D costs.

The Federal Circuit also rejected the government's policy argument that a contractor would "game the system" by charging to government contracts the costs necessary to complete a commercial contract, holding in the first instance that the government has encouraged contractors to engage in IR&D to "enrich and broaden the spectrum of technology available to the Department of Defense" and second that the government's theory would have the absurd result of allocating all IR&D costs to the first contract for which the research and development work would be deemed necessary.

Hence, contractors are obligated only to segregate those costs that are express contract requirements from IR&D and charge only those costs directly to contracts. Under the concept of concurrent IR&D, contractors may continue to incur allowable IR&D for ongoing development efforts that may relate to a contract, but are not a specific requirement of that contract.

We hope that you find this advisory helpful. If you would like more information on this or other government contract issues please feel free to contact:

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