THE GOVERNMENT CONTRACTOR®

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Information and Analysis on Legal Aspects of Procurement

Vol. 52, No. 14 **April 7, 2010**

Decisions

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Fed. Cir. Adopts Broad View Of IR&D

ATK Thiokol, Inc. v. U.S., 2010 WL 987007 (Fed. Cir. March 19, 2010)

A contractor properly classified development costs as independent research and development (IR&D) and treated them as indirect costs because the parties' contract did not specifically require the development work, the U.S. Court of Appeals for the Federal Circuit has held. The Court rejected the Government's argument that indirect allocation is improper for the costs of any development work necessary for performance, even if the contract does not expressly require the work.

ATK Thiokol Inc. manufactures rocket motors for government and commercial buyers. Its Castor motors are "strap on" motors designed to attach to a launch vehicle and provide additional thrust. In the 1990s, ATK started developing the Castor IVA-XL rocket, which was built in Huntsville, Ala. After a 1995 decision to close the Huntsville plant and restructure operations, ATK analyzed the Huntsville products and determined that there was a market for the Castor IVA-XL motor. To upgrade the motor and make it more competitive, ATK began development efforts, including design modifications and test firing the motor. From 1995 through 1999, ATK marketed the upgraded motor to various potential customers, including McDonnell Douglas Corp., Lockheed Martin Corp. and the Air Force.

In 1996, Mitsubishi Heavy Industries sought to buy modified Castor IVA-XL motors for Japanese government launch vehicles. Mitsubishi agreed to pay for adapting and attaching the motors to launch vehicles, but refused to pay for the development effort to upgrade the motor. In June 1997, Mitsubishi and ATK agreed to a statement of work requiring ATK to deliver the motor it was updating "to support the general requirements of the strap-on market." In October 1998, ATK and Mitsubishi signed a final contract, which called for a lump-sum payment for each upgraded motor and a price for modifying each motor to fit Japanese launch vehicles. The contract did not include a provision requiring Mitsubishi to pay for the development effort, which began in July 1997.

ATK accounted for the development effort costs as indirect IR&D costs and in 1997 disclosed them in a proposed advance agreement submitted to the Department of Defense divisional administrative contracting officer (DACO). ATK allocates IR&D costs to all of its contracts, including Government contracts.

Under its consistent, disclosed accounting practice, ATK treated research and development costs as indirect costs unless (1) the contract in question specifically required ATK to incur the cost, (2) the contract paid for the cost, or (3) the cost had no reasonably foreseeable benefit to more than one cost objective. From 1990–1997, DOD concluded that this accounting practice complied with accounting regulations for Government contracts.

In March 1999, the DACO stated that he intended to disallow the development costs because the Federal Acquisition Regulation definition of IR&D excludes efforts "required in the performance of a contract." In the DACO's view, the development effort costs were necessary to perform the Mitsubishi contract and therefore did not qualify as IR&D.

ATK challenged the DACO's decision, and the U.S. Court of Federal Claims ruled that ATK properly treated the development effort costs as indirect IR&D. See 48 GC ¶ 8. The Government appealed that decision to the Federal Circuit.

Several regulations govern the classification of R&D and IR&D costs. Cost Accounting Standard 402 defines direct cost as "any cost which is identified specifically with a particular final cost objec-

tive." An indirect cost is "any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives, or at least one intermediate cost objective." CAS 402-30(a)(3), (4). CAS 402 gives a contractor considerable freedom in classifying particular costs if the contractor consistently applies the classification, the Court said.

Two parallel regulations determine whether costs qualify as IR&D. FAR 31.205-18 determines whether costs are allowable IR&D charges, and CAS 420 determines whether those costs are allocable to a contract. The FAR and CAS define IR&D as excluding costs that are "required in the performance of a contract." FAR 31.205-18(a); CAS 420-30(a)(6).

Under CAS 402, ATK properly treated the development effort costs as indirect costs. The Mitsubishi contract did not specifically require those costs, and ATK's disclosed and established cost accounting practice treated them as indirect because they were not paid for or required by a particular contract and had a reasonably foreseeable benefit to more than one contract, the Court said.

Finding that ATK properly treated the development effort costs as indirect costs does not end the inquiry. Depending on a contractor's disclosed or established cost accounting practices, a contract may treat some R&D costs as indirect costs because they benefit an entire product line, even if they are expressly required by a particular contract and thus do not qualify as IR&D.

Whether the development effort costs qualify as IR&D costs turns primarily on the meaning of the phrase "required in the performance of a contract" in the definition of IR&D, the Court said. That phrase has been a subject of controversy since it first appeared in the Armed Services Procurement Regulation in 1971.

The Government interpreted the phrase as focusing on whether the work was necessary to perform the contract, rather than on whether the contract expressly required the work. Thus, in the Government's view, the development effort costs are not IR&D because, although the Mitsubishi contract did not expressly require the background R&D work, that work was necessary for ATK to upgrade the Castor motor.

The Government contended that the regulatory phrase excluding costs from IR&D should be construed broadly because it does not simply exclude costs "required by a contract." Instead, it uses broader language excluding costs "required in the performance of a contract." In contrast, ATK contended that the word "required" must refer to a contract requirement. The Court found neither textual argument persuasive.

The Court also found the regulatory history inconclusive. It noted that the committee responsible for changes to the regulation declined industry's suggestion to limit the exclusion from IR&D to costs "specifically required" by the contract, but also declined the U.S. Comptroller General's suggestion to broaden the exclusion to include costs "implicitly required" by the contract.

To resolve the interpretation issue, the Court turned to the interpretation of the identical phrase in the regulatory definition of bid and proposal (B&P) costs. The FAR and CAS define B&P costs to include costs incurred in preparing, submitting and supporting bids and proposals, but not to include the costs of effort "required in the performance of a contract." FAR 31.205-18(a); CAS 420-30(a)(2). Treating B&P costs as indirect overhead is logical because they benefit a contractor's entire business, rather than a specific existing contract, the Court said, citing *Boeing Co. v. U.S.*, 862 F.2d 290 (Fed. Cir. 1988).

A CAS provision, known as interpretation no. 1, gives important guidance on whether proposal costs constitute B&P costs and whether they should be charged to a single contract:

> [C]osts incurred in preparing, submitting, and supporting proposals pursuant to a specific requirement of an existing contract are considered to have been incurred in different circumstances from the circumstances under which costs are incurred in preparing proposals which do not result from such specific requirements. The circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor.

CAS 402-61(c).

Interpretation no. 1 distinguishes proposal costs "specifically required by" an existing contract from proposal costs that "do not result from such specific requirements." The former relate only to a particular contract, but the latter relate to all of the contractor's work and thus qualify as B&P costs. Interpretation no. 1 effectively equates proposal costs that are "required in the performance of a contract" with

costs that are "specifically required by the provision of a contract," the Court said.

Relying on interpretation no. 1, the Federal Circuit in *Boeing* held that proposal costs not specifically required by a contract are "properly allocated as indirect B&P costs." The *Boeing* court noted the different circumstances underlying proposal costs that are specifically required by an existing contract and proposal costs that relate to a contractor's entire work. *Boeing* held that it is improper to require similar accounting for B&P costs that are related to or caused or generated by a contract, and those proposal costs that are specifically required by the contract.

In *ATK Thiokol*, the Court applied the same analysis to the similar category of IR&D costs. Noting that the identical regulatory language in the definitions of B&P costs and IR&D costs should have the same interpretation in both contexts, the Court held that "required in the performance of a contract" means costs that the contract specifically requires.

The Court rejected the Government's assertion that this interpretation would allow contractors to game the system by shifting commercial contract costs to the Government. The Court said that IR&D benefits both contractors and the Government by encouraging research. Moreover, directly charging IR&D costs to a contract for which the research and development work is deemed necessary "could have the perverse effect of charging all of the research and development costs for a proposed product line against the first contract for the products in that line." That accounting approach would disproportionately burden the contract that happened to be first, the Court said.

Accordingly the Federal Circuit held that, because the R&D costs were related to the Mitsubishi contract but were not specifically required by that contract, they were indirect IR&D costs under applicable regulations.

✦ **Practitioner's Comment**—The *ATK Thiokol* decision finally resolves the long-raging battle over the concept of an explicit contract requirement, which contractors have espoused, and an implicit contract requirement, which the Government has argued, in determining whether development effort is "required in the performance of a contract" within the FAR definition of IR&D. This decision should not be tallied as a "win for contractors"—it benefits both contractors and the Government. More on that later.

Although the COFC and the Federal Circuit arrived at the same conclusion, it is interesting to consider the different approaches these two courts took to analyze the FAR. The COFC performed a detailed analysis that interpreted the FAR in the context of the type of cost incurred. Judge Braden should be applauded for her exhaustive analysis of the regulatory history, as well as of the nature of the cost as IR&D, an indirect cost. The COFC considered the definitions of direct and indirect costs per the FAR, as well as the contractor's CAS disclosure statement to determine whether the contractor properly treated the costs as indirect. Like the Federal Circuit, it examined the related language in the CAS. In the end, the COFC's analysis relied substantially on the intent of the parties to the contract at issue. The COFC looked to the terms of the contract, holding that whether a "cost is 'required in the performance of a contract' is controlled by the contracting parties' intent, as determined by traditional contract interpretation on a case-by-case basis." *ATK Thiokol, Inc. v. U.S.*, 68 Fed. Cl. 612 (2005). The COFC concluded that the motor upgrade and associated costs were not part of the Mitsubishi contract.

The Federal Circuit took a more traditional, legalistic approach. Ultimately, it relied on the identical language from the definition of B&P costs and based its conclusion strictly on regulatory guidance found in interpretation no. 1 of CAS 402, as discussed in the analysis above. Another important aspect of the Federal Circuit's decision, however, is that it rejected the holding in *U.S. v. Newport News Shipbldg., Inc.*, 276 F. Supp. 2d 539 (E.D. Va. 2003), in which the district court held that "required in the performance of a contract" includes an implicit requirement.

At the opening of this Practitioner's Comment, I stated that the result in this case really benefits both contractors and the Government. This relates to one of the Federal Circuit's final conclusions about the effect of the Government's position. Taken to its logical end, by defining "required in the performance of a contract" to mean any implicit requirement would "have the perverse effect of charging all of the research and development costs for a proposed product line against the first contract for the products in that line," as the Federal Circuit concluded. This is what has always been perplexing about the Government's position, because that first contract could well be a Government contract. Clearly, the Government's mo-

tivation in both *Newport News* and *ATK Thiokol* was to convert costs to commercial contracts. However, if the first contract in line had been a Government contract, under the "implicit" theory, the Government contract would have to bear the costs. Recall that *Newport News* involved approximately $80 million of IR&D costs. A single Government contract could equally be saddled with tens of millions of dollars under the "implicit" theory. Thus, apart from being proper treatment of an indirect cost, the Federal Circuit's decision is a sound resolution on all fronts.

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