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Independent R&D Costs: The Latest Approach to Limit Allowability

BY PAUL E. POMPEO

The Department of Defense recently issued a proposed rule that would condition the allowability of Independent Research and Development (''IR&D'') costs charged to DOD contracts on a reporting requirement. 76 Fed. Reg. 11414 (Mar. 2, 2011) (proposing to amend Defense Federal Acquisition Regulation Supplement 231.205-18). The proposed rule is concise, but far-reaching. For any DOD contractor with annual IR&D costs in excess of $50,000, the proposed rule would require the contractor to report IR&D projects to the Defense Technical Information Center (''DTIC''). The proposed rule does not identify, however, the details of the content that a contractor will have to report. The contractor must update inputs to the reporting system ''at least annually'' and the information must be made available to the cognizant Administrative Contracting Officer (''ACO'') and the Defense Contract Auditing Agency (''DCAA'') ''to support the allowability of the costs.'' *Id.* at 11415. Contractors must also report when the project is completed.

According to the DOD, the policy for this change is ''to increase effectiveness by providing visibility into the technical content of industry IR&D activities to meet DOD needs and promote the technical prowess of the industry.'' *Id.* at 11414. The DOD further explains that ''[w]ithout the collection of this information, DOD will be unable to maximize the value of the IR&D funds

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that it disburses without infringing on the independence of a contractor to choose which technologies to pursue in its independent research and development.'' *Id.* at 11415.

Historical Context. The government has struggled over the years in its balance between the need to support IR&D to assure that national defense benefits from the most advanced technology and the expenditure. A thorough analysis of the history of the IR&D cost principle, which dates back to the Armed Services Procurement Regulations (''ASPR''), is unnecessary here. *See* J. Chierichella, *IR&D vs. Contractor Effort*, Cost, Pricing and Accounting Report at 5-6 (Feb. 1990) (discussing the history of the IR&D cost principle); T. Barletta & G. Wimberly, Jr., *Allowability of Independent Research and Development Costs Under FAR 31.205-18: A Proposal for Regulatory Reform*, 29 Pub. Cont. L.J. 113, 115-118 (1999). Nevertheless, some historical background is useful to understand the contemporary context.

In the late 1960s, DOD engaged in an extensive review of its regulations governing the allowability of IR&D costs. Then, as today, the DOD was concerned with the balance between technical advancement and cost.

> The Department of Defense (DOD) considers that some significant amount of contractor-initiated research and development is essential to both a balanced national R&D program in the national security area and a progressive, independent defense industry having the training and active technical capability required to be creatively responsive to DOD's needs in a timely manner. Such independent effort is also considered a necessary cost of doing business and the essence of long-range industry competition. It is therefore DOD's policy to allow its suppliers to recover those costs in this area which are both reasonable and allocable to its contracts.

Defense Procurement Circular at 2 (Feb. 17, 1969) (proposing amendments to ASPR 15-205.35). The DOD amended the cost principle to remove dependence on advance agreements for cost reasonableness, and shift to a formulaic approach applicable to non-Contractor Weighted Average Share (CWAS)-approved contractors. Non-CWAS-qualified contractors were, thus, subject to a ceiling on IR&D. Defense Procurement Circular 90 (Sept 1, 1971).

About twenty years later, the National Defense Authorization Act for Fiscal Year 1991 imposed a ceiling on the allowability of IR&D costs for companies recovering IR&D and bid and proposal (''B&P'') costs exceeding $7,000,000 through government contracts. Pub. L. 101-510; *see also* Pub. L. 91-441; Federal Acquisition Regulation (''FAR'') 31.205-18(c)(1) (1996). The government continued to adhere to the concept of a ceiling by negotiating an advance agreement. Contractors who failed to initiate negotiation of the required advance agreement before the end of the fiscal year for which the agreement was required would not be able to recover the IR&D expense as an allowable cost. FAR 31.205-18(c)(1)(i)(D) (1996). The National Defense Authorization Act for Fiscal Years 1992 and 1993 applied limitations to the allowability of IR&D costs by ''major contractors'' to a specified formula. Pub. L. 102-190; *see also* FAR 31.205-18(c)(2) (1996).

By the late 1990s, however, the government transitioned to a policy by which IR&D costs were allowable to the extent they were reasonable and allocable. FAR 31.205-18(c) (1998). The government removed the complicated formulas and ceilings for determining the allowability of IR&D costs under government contracts. And there were no distinctions based on a status as a ''major contractor.'' Nevertheless, IR&D costs have remained a candidate for advance agreements. *See*, e.g., FAR 31.109(h)(5) (2011). DOD regulations, however, continued to condition the allowability of IR&D costs of major contractors (those with more than $11 million in IR&D/B&P costs) charged to DOD contracts to ''projects that are of potential interest to DOD.'' DFARS 231.205-18(c)(ii)(B) (2011) (including a list of intentions).

Despite the relaxed FAR rules, the government launched a series of challenges to the allowability of IR&D based on the concept that a cost was ''required in the performance of a contract,'' and thus not allowable IR&D, when the effort was ''implicitly'' required to perform a contract. In the cases litigated, the government sought to shift costs from indirect IR&D expense to direct costs of commercial contracts. *United States* v. *Newport News Shipbuilding, Inc.*, 276 F. Supp.2d 539 (E.D. Va. 2003); *ATK Thiokol* v. *United States*, 68 Fed. Cl. 612 (2005); *see also United States v. General Dynamics Corp.* 828 F.2d 1356 (9th Cir. 1987) (The underlying facts of the infamous DIVADS case involved the allocation of IR&D costs. The government alleged that costs should have been charged to the contract, presuming it to be firm fixed price, rather than to the IR&D pool). Last year, the United States Court of Appeals for the Federal Circuit resolved that matter to mean ''specifically required by the provisions of a contract.'' *ATK Thiokol, Inc. v. United States*, 598 F.3d 1329 (Fed. Cir. 2010), *reh'g denied* (July 13, 2010). The current, proposed rule, seeks to tighten the allowability of IR&D costs again.

Coordinating with Industry. While the cases involving the recovery of IR&D costs were wending their way through the courts, the Deputy Undersecretary of Defense, International Technology Security, presented the government's policy concerns regarding IR&D to industry in a presentation in September 2008. Independent Research & Development (IRAD) DST Kick-Off (Sept. 10, 2008). Those considerations ultimately percolated into the March 2, 2011 proposed rule. The DOD established a Defense Support Team (''DST'') that was to coordinate with the defense industry and propose DFARS changes, ''if required.'' Of particular concern was the ability of DOD to secure greater information about industry IR&D programs. DOD specifically inquired of industry:

> What inducements/incentives are needed to gain industry cooperation in populating the DTIC IRAD site? Would some other tool or some other process be more appropriate?

Id. slide 6. The DOD recognized, however, that the DTIC database was not ''ideal,'' in part due to proprietary concerns. *Id.* slide 7. A stated near-term goal was to direct the DCAA to provide reports on IR&D with costs broken out. Long-term actions included improvement of the DTIC software and to ''[r]evise the present IRAD reimbursement mechanism from 'one size fits all' to one that rewards companies that report their activities to the DTIC Database. This is intended to encourage companies to report their activities and provide their information to the Department.'' *Id.* slide 10.

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Clearly, these motives translated into the current, proposed rule, which is a bit more than ''encouragement.''

DOD states that the proposed reporting requirements are ''mandated by 10 U.S.C. 2372'', 76 Fed. Reg.1141 (Mar. 2, 2011); however the reporting requirements are *permissive*. 10 U.S.C. 2372(c)(3)(B) (providing that regulations ''may'' include additional controls, including those to report on contractor IR&D programs).

Implications for Contractors. The proposed rule is significant to government contractors for several reasons. First, the reporting requirement is broad-reaching due to its extraordinarily low threshold. The proposed rule would apply to a contractor with annual IR&D costs of only $50,000. Considering that the current restrictions on IR&D costs regarding whether IR&D projects are of potential interest of the DOD focus on contractors with IR&D in the range of $11 million and more (DFARS 231.205-18(c)(iv) (2011), this low threshold for reporting would apply to virtually every DOD contractor that engages in some form of IR&D. Recall this is an ''annual'' amount, not a program amount.

Second, the reporting requirement continues to rely on the DTIC database that, as noted above, has been the subject of concern about controls on the proprietary nature of information provided. It remains to be seen whether the government has made adequate modifications to the software to assure contractors protection of the information loaded into the DTIC.

Third, the proposed regulation does not delineate the type of information contractors will need to provide. If the information sought is generic, it may not implicate competitive and proprietary concerns. The proposed rule merely states that contractors must input data in accordance with the ''on line input forms and instructions.'' 76 Fed. Reg.1141, 11415 (Mar. 2, 2011). Moreover, because the information sought is not expressly set out in the regulations, it is easy for the government to change the input requirements outside of the regulatory notice process. Whereas this might provide opportunities for government-industry cooperation on the content of the DTIC database, it also leaves contractors vulnerable to changes in requirements that will ultimately affect allowability. As structured, the proposed rule sets out the reporting requirement under ''limitations'' applicable to the allowability of IR&D costs. Thus, a contractor may find itself in the predicament of deciding whether to disclose certain data that it considers tightly-held and proprietary or to forgo the allowability of certain IR&D costs.

Finally, and of significant importance, the proposed rule would expressly require contractors to provide copies of the input data not only to the ACO, but also to the DCAA. *Id.* The DCAA has been gaining more and more authority (actual or presumptive) over the past years. The proposed rule provides that the purpose of providing the data to the DCAA is to ''support the allowability of the costs.'' *Id.* Invariably, the DCAA will use the data to challenge the allowability of contractor IR&D costs. One should question whether a local DCAA auditor should have authority to assess the propriety of an IR&D project when determining the allowability of IR&D costs. The proposed rule portends more allowability questions for defense contractors.

Conclusion. Comments on the proposed rule are due on or before May 2, 2011. It is clear from the government's engagement of industry on the subject of IR&D that the government would welcome input from contractors. Given the potential breadth of the proposed regulations, contractors individually and industry associations should scrutinize the proposed regulation to close the many potential gaps that the proposed rule leaves. These include the propriety of such a low dollar threshold for the reporting requirement; greater clarity on the security of the DTIC software and site, as well as the content of the report; and the role of the DCAA, including constraints on the use of IR&D reporting data to determine cost allowability so as to avoid an avalanche of disputes over the allowability of IR&D expense.