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Maximizing Contractor Recovery of IR&D Costs: Federal Circuit Affirms *ATK Thiokol*

By Thomas A. Lemmer, Phillip R. Seckman, and Taylor M. Menlove

Thomas A. Lemmer

Phillip R. Seckman

Taylor M. Menlove

Research and development (R&D) is a vital component of many government contractors' businesses. The government marketplace demands that contractors consistently improve existing technologies and develop new technologies to provide needed products and services to the government.

For the last four decades, however, there has been much debate regarding when contractors can recover R&D costs as indirect costs, or "independent research and development" (IR&D) costs, spread over multiple contracts, as opposed to direct costs of a single contract. This debate centers on the regulatory requirement that R&D costs are recoverable as indirect IR&D costs unless the R&D effort is "required in the performance of a contract." The government repeatedly has argued that this phrase should be interpreted broadly, encompassing not only R&D effort specifically required by contract terms, but also any R&D "implicitly required" or "necessary" for contract performance. Contractors, in response, have argued that the phrase should be interpreted narrowly, only applying to R&D effort specifically required by contract terms. Based on this uncertainty, government auditors have aggressively challenged contractor recovery of IR&D costs, and numerous False Claims Act violations have been alleged.

On March 19, 2010, the United States Court of Appeals for the Federal Circuit (Federal Circuit) provided much needed clarity regarding when R&D costs are properly recoverable under government contracts as IR&D costs. The Federal Circuit's decision, *ATK Thiokol, Inc. v. United States*,[1] addressing an issue of first impression at the court, held that R&D effort is only "required in the performance of a contract" when the effort is *specifically* required by a contract's terms. The Federal Circuit's judgment affirmed the decision of the United States Court of Federal Claims (COFC) issued on November 30, 2005.[2]

The Federal Circuit's decision, in combination with the COFC's decision, should end much of the uncertainty regarding the proper interpretation of the regulatory phrase "required in the performance of a contract." Further, the Federal Circuit's decision confirms that "parallel" IR&D and the use of "branch technology" are appropriate, so long as contracts are properly negotiated and drafted.

The Federal Circuit's decision also provides added confidence to contractors that their adherence to the terms of their Cost Accounting Standard (CAS) Disclosure Statements will guide whether R&D costs are properly classified as indirect costs under CAS 420 and are allowable under Federal Acquisition Regulation (FAR) 31.205-18. Indeed, the Federal Circuit affirmed that contractors, within the broad parameters established by the CAS, are free to adopt cost accounting practices that make sense for their businesses and that, once established and not otherwise non-

Thomas A. Lemmer is a partner, and Phillip R. Seckman and Taylor M. Menlove are associates, in the Denver office of McKenna Long & Aldridge LLP.

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compliant, bind the contractor and the government.

Finally, the Federal Circuit's decision provides guidance on proper contractor accounting for bid and proposal (B&P) costs, costs that are similar to IR&D costs and governed by the same regulatory framework. The decision also ensures consistency between cost accounting and data rights regulations.

Regulatory Framework for Recovery of IR&D and Other Indirect Costs

Understanding the Federal Circuit's *ATK* decision begins with understanding the regulatory framework under which contractors seek recovery of IR&D costs and other indirect costs. Two regulations address when R&D costs are indirect IR&D costs and when these costs are direct costs of a contract. Both regulations require that R&D costs be treated as IR&D costs unless the R&D effort is "required in the performance of a contract."

CAS 420, which governs the allocation of IR&D and B&P costs, states that IR&D does not include the costs of effort "sponsored by a grant [or] *required in the performance of a contract*" (emphasis added). CAS 420, therefore, requires that R&D costs that have a broad benefit be classified as "independent" indirect costs allocated to multiple contracts. By contrast, when R&D costs are "required in the performance of a contract," they must be treated as direct costs because only one contract is benefited.

Where CAS 420 governs the allocation of IR&D and B&P costs, FAR 31.205-18 governs the allowability of these costs. Like CAS 420, FAR 31.205-18 defines IR&D costs as costs resulting from R&D effort that is not "required in the performance of a contract." This FAR section further provides that R&D costs accounted for under CAS 420 as IR&D costs are allowable IR&D costs.

Important to the Federal Circuit's decision in *ATK* is that both CAS 420 and FAR 31.205-18 address the accounting for and allowability of B&P costs, for relevant purposes, in an identical manner to IR&D costs. As with IR&D costs, both the CAS and the FAR provisions use the same limiting phrase, "required in the performance of a contract," to define costs that do *not* qualify as B&P costs. Indeed, as discussed below, the Federal Circuit's decision turned in large part on the fact that IR&D and B&P costs are defined by the same regulatory language.

Notably, the phrase "required in the performance of a contract" has remained unchanged in relevant government contract procurement regulations since 1971. Since its inception, however, it has been the subject of significant debate between the government and contractors. Beginning in the 1990s, and prior to *ATK*, there had been a number of federal court decisions, including *Newport News*, that reinforced the government's view that "required in the performance of a contract" should be interpreted broadly to mean any development "necessary" to or "implicitly required" by a contract.[3]

Based on these cases, government auditors had become increasingly aggressive in attempting to prevent the government from paying for what the government viewed as "commercial development" by asserting that such development was "required in the performance" of contractors' commercial contracts and, therefore, not IR&D. This resulted in increased questioning of contractors' IR&D costs and created increased uncertainty and risk of fraud allegations for contractors. As discussed below, the Federal Circuit's decision in *ATK*, combined with the COFC's decision, provides contractors with the basis to defeat such government arguments.

In addition to CAS 420 and FAR 31.205-18, CAS 402 also governs contractor recovery of IR&D costs. Further, CAS 402 Interpretation No. 1 addresses when the costs of B&P efforts may be treated as indirect B&P costs. Although Interpretation No. 1 does not address IR&D costs, it is relevant given the near identical accounting for IR&D and B&P.

CAS 402 requires consistency in contractor classification of costs as direct or indirect. Specifically, CAS 402 requires that "[a]ll costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives."[4] The rule defines a "direct cost" as "any cost which is identified specifically with a particular final cost objective."[5] Further, CAS 402 defines an "indirect cost" as "any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives . . . ."[6]

CAS 402 Interpretation No. 1, which the CAS Board issued in 1976, before issuing CAS 420, stated that costs of B&P efforts must be treated as indirect costs when there is no "specific requirement" for the effort in a contract. Importantly, when issuing Interpretation No. 1, the CAS Board chose the "specific requirement" standard over broader language "such as 'related to,' 'arising from,' 'identified with' or 'directly associated with.'"[7] Indeed, the terms the CAS Board rejected are nearly identical to the "necessary" or "implicitly required" standard adopted in *Newport News* and argued by the government in *ATK*.

After issuing CAS 402 Interpretation No. 1, the CAS Board issued CAS 420, effective in 1980, which defined both IR&D and B&P costs as costs not "required in the performance of a contract." When it issued CAS 420, the CAS Board did not withdraw Interpretation No. 1, or provide, or even imply, that CAS 402 Interpretation No. 1 and CAS 420 were inconsistent. The CAS Board's retention of CAS 402 Interpretation No. 1, despite defining B&P and IR&D costs in CAS 420, manifests the board's intent that "required in the performance of a contract" means that no "specific requirement" for the R&D or B&P effort existed in a contract.

Moreover, courts consistently have applied the "specific requirement" standard from CAS 402 Interpretation No. 1 to determine when B&P costs properly are charged direct to a contract. For example, in *Boeing Co. v. United States*,[8] the Federal Circuit applied Interpretation No. 1 to determine proper accounting for B&P costs. The issue before the court was whether a differing circumstance existed that warranted charging certain related B&P costs direct and

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some indirect. To determine the proper accounting, the court relied on CAS 402 Interpretation No. 1 and its guidance that a "specific requirement in an existing contract" is the differing circumstance that triggers charging B&P costs direct to a contract.

The ATK Thiokol Dispute

The dispute in *ATK* resulted from efforts in the 1990s by ATK's predecessor, Thiokol Corporation (hereinafter, ATK), to upgrade a variant of its Castor IV rocket motor to help increase sales to both commercial and government customers. ATK management had decided to develop the upgraded motor after the marketplace had shown genuine interest in the upgraded motor. ATK marketed the upgraded Castor IV motor to various potential customers, including McDonnell Douglas, Lockheed Martin, and the United States Air Force.

In February 1996, Mitsubishi Heavy Industries expressed serious interest in purchasing the upgraded motor. Mitsubishi refused from the beginning, however, to pay for the development effort required to upgrade the motor, although it agreed to pay for development necessary to modify the upgraded motor for attachment to the Japanese launch vehicle. Accordingly, the contract between ATK and Mitsubishi for an upgraded Castor IV motor stated, as a precondition, that ATK would provide a ready-to-launch upgraded motor. The Mitsubishi contract also did not include a price or statement of work (SOW) for the effort needed to upgrade the motor. Further, ATK had documentation that the price it negotiated with Mitsubishi excluded any effort to upgrade the motor.[9]

In July 1997, when ATK began the upgrade development effort, the company's management determined that it was reasonably possible that the upgraded Castor IV motor would be sold under multiple government and commercial contracts, not just under the Mitsubishi contract. Based on this determination, management approved spending company R&D funds to perform the effort needed to upgrade the motor. Management also determined that the upgrade costs would be accounted for as IR&D costs. This decision was consistent with ATK's disclosed cost accounting practices for R&D, as well as its past practice in accounting for R&D costs relating to certain government programs. Under disclosed and consistently followed cost accounting practices, ATK treated R&D costs as IR&D costs unless:

> (1) the particular contract in question specifically required that ATK 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.[10]

Shortly after making this accounting decision, ATK proposed an advance agreement to its divisional administrative contracting officer (DACO) to establish the costs as properly allocable and allowable IR&D costs. Despite the fact that ATK had classified the costs in a manner consistent with its disclosed and approved accounting practices, the DACO disallowed the costs on the basis that they were "required in the performance of" the Mitsubishi contract and, therefore, had to be charged direct to that contract.

COFC Decision: The Castor IV Motor Upgrade Was Properly Classified as IR&D

On appeal from a contracting officer's final decision denying ATK recovery of the Castor IV upgrade costs as IR&D, the COFC found that ATK properly had allocated the upgrade costs because the upgrade effort was not "required in the performance of" the Mitsubishi contract. Specifically, the court found, following a detailed discussion of the relevant regulatory history applicable to IR&D costs, that determining whether R&D effort is "required in the performance of a contract" is a function of the contractor's cost accounting practices and CAS 420, CAS 402, and CAS 402 Interpretation No. 1, all of which the court said focused on what the contract required. Thus, the proper cost classification of ATK's R&D costs was a matter of contract interpretation.

The COFC then determined that the Castor IV upgrade effort was not "required in the performance of" the Mitsubishi contract. The court found that ATK and Mitsubishi did not *intend* the upgrade effort to be "required in the performance of" the contract. Further, the contract's terms neither required the effort nor included a price for the effort. Rather, the contract's terms reflected the parties' belief that a market existed for the upgraded Castor IV motor and, accordingly, that there would be multiple purchasers of the upgraded motor.

Government's Appeal: The COFC Misinterpreted "required in the performance of a contract"

On appeal, the government argued that the COFC's legal analysis was incorrect. Specifically, the government contended that the lower court misinterpreted relevant regulations because "required in the performance of a contract," based on its plain language, precludes all R&D costs, whether specifically or implicitly required by a contract, from being classified as IR&D.

The government thus argued, based on *Newport News*, that the Castor IV upgrade effort was "required in the performance of" the Mitsubishi contract because ATK could not meet the contract requirement to provide Mitsubishi an upgraded motor without first performing the upgrade effort.[11] According to the government, because the upgrade effort was necessary to ATK's ability to perform the Mitsubishi contract, the effort was "required in the performance of" the contract. The government also argued that the COFC's decision should be reversed on policy grounds because the decision enabled contractors to "game the system" by improperly shifting commercial contract costs to the government.

In opposition, ATK argued that the COFC's decision achieved harmony between the regulatory definitions of IR&D and B&P costs and that because both IR&D and B&P costs are defined using the same limiting phrase, "required in the performance of a contract," the definitions of these costs

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should be interpreted consistently. According to ATK, therefore, the COFC properly extended the definition of B&P costs contained in CAS 402 Interpretation No. 1—the "specific requirement" standard—to IR&D costs.

ATK also argued that the COFC's decision was consistent with the Federal Circuit's holding in *Boeing*, where the court relied on CAS 402 Interpretation No. 1's "specific requirement" standard to determine whether B&P costs should be charged direct or indirect. Thus, based on the fact that IR&D and B&P costs are defined using the same limiting phrase, ATK argued that *Boeing* and CAS 402 Interpretation No. 1 should control the interpretation of IR&D costs as well.

ATK further argued that the government's reliance on *Newport News* was wrong and that the court in *Newport News* ignored the fact that IR&D and B&P costs are subject to the same regulatory framework as well as the Federal Circuit's precedent in *Boeing*. ATK contended, therefore, that the COFC had properly rejected the *Newport News* standard.

Next, responding to the government's policy arguments, ATK contended that CAS 402 and the requirement that contractors comply with established cost accounting practices precluded contractors from "gaming the system." ATK pointed out specifically that the requirement that contractors follow established accounting practices disclosed to, and approved by, the government in CAS Disclosure Statements would prevent any such manipulation.

Finally, ATK argued that the government's interpretation created a countervailing and adverse impact on IR&D, known as the "first in line" problem: If the government's interpretation of "required in the performance of a contract" as including any effort "implicitly" required were to be adopted, the first purchaser of any product, whether a government or commercial customer, would have to pay all R&D costs associated with that product or the contractor would have to recognize its R&D costs as a loss for any successful R&D effort.

Accordingly, ATK argued, the government's interpretation would actually harm the government's interest whenever the government itself was the first purchaser of a product that benefited from significant contractor R&D effort. In this circumstance, the government's broad interpretation of the IR&D exclusion would result in significant R&D costs being considered a direct cost of a government program. Accordingly, the government no longer would benefit from contractors' ability to spread R&D costs for government products that had potential commercial application across both government and commercial work, as the government had done previously under agreement with ATK.

Federal Circuit Affirms COFC: The Castor IV Motor Upgrade Was Properly Classified as IR&D

The Federal Circuit affirmed the COFC's decision and in doing so also provided much needed guidance by establishing that R&D effort is "required in the performance of a contract," and therefore not properly accounted for as IR&D, *only* when the effort is "specifically required by the terms of an existing contract." To reach this conclusion, the Federal Circuit applied settled principles of regulatory construction.

First, the Federal Circuit considered whether the phrase "required in the performance of a contract" has a clear meaning based on the plain language of CAS 420 and FAR 31.205-18. The court concluded that the regulation is "ambiguous," without a clear meaning.[12] In so doing, the court rejected the government's plain language argument based on *Newport News* that "required in the performance of a contract" means effort both specifically and implicitly required by a contract. By rejecting the government's argument, the court rejected the legal analysis that forms the basis for the *Newport News* decision.

Second, the Federal Circuit considered the relevant regulatory history to determine whether it aided in interpreting the phrase "required in the performance of a contract." While the court credited the COFC's "thorough and well-documented review of the regulatory history," it concluded that "[l]ike the text . . . the regulatory history is inconclusive."[13]

Unable to rely on the plain language or the regulatory history, the Federal Circuit then turned to other relevant regulations, specifically CAS 402 Interpretation No. 1 and the settled interpretation of B&P costs. The court held that while Interpretation No. 1 does not address IR&D costs, IR&D costs cannot be interpreted differently from B&P costs because such an outcome would "result in a construction in which identical regulatory language . . . would be interpreted differently for IR&D than for B&P."[14] Thus, the Federal Circuit concluded that CAS 402 Interpretation No. 1 and the court's own decision in *Boeing* governed the proper interpretation of the IR&D costs definition.

Relevant to the Federal Circuit's decision, CAS 402 Interpretation No. 1 provides:

> [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.[15]

Based on this language, the Federal Circuit explained that the "effect of Interpretation No. 1 is to equate the B&P [and IR&D] 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.'"[16] The court concluded, then, that the phrase "required in the performance of a contract" means that costs resulting from efforts specifically required by a contract do *not* qualify as B&P or IR&D costs.[17]

The Federal Circuit also rejected the government's policy argument. The court found that there was no risk that government contractors, as suggested in the government's

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brief, would "game the system" to charge the government for costs that do not properly qualify as IR&D. In addition to rejecting the government's argument, the court identified as a chief concern the potential detrimental impact to the government from the "first in line" problem:

> [The government's approach] would either disproportionately burden the contract that happened to be first in line or ensure that the first contract would be a losing one. For research that, by hypothesis, benefits multiple potential contracts, both commercial and government, allocating general research and development costs in that manner is not sensible as a policy matter.[18]

Moreover, the court recognized that IR&D benefits both the government and contractors:

> Spreading IR&D costs across multiple contracts encourages general research that enables the contractor to innovate, to maintain a high level of technological sophistication, and ultimately to improve the products it offers the government.[19]

Accordingly, the Federal Circuit concluded that public policy supports categorizing R&D effort that benefits multiple contracts as IR&D, the costs of which are recoverable under government contracts.

Impact of the Federal Circuit's Decision

ATK provides much needed guidance regarding IR&D costs. Most importantly, the decision clarifies when R&D effort is not independent, requiring that resulting costs be classified as direct contract costs. The decision also establishes consistent treatment of B&P and IR&D costs, and provides "best practices" for government contract cost accounting. Finally, the decision ensures proper consistency between cost accounting and technical data rights regulations.

The court's decision clarifies that R&D effort is "required in the performance of a contract," thus precluding resulting costs from being IR&D costs, only when the effort is "specifically required by the terms of an existing contract." Thus, absent a specific contract requirement, contractors confidently can classify R&D costs as IR&D and charge such costs indirect.

Further, based on the Federal Circuit's decision in *ATK*, contractors now can confidently define IR&D in their CAS Disclosure Statement as R&D effort that is not "specifically required by a contract." Indeed, the facts of *ATK* provide added clarity in implementing this concept in a Disclosure Statement. Based on ATK's accounting practices, it would be appropriate for other contractors to define "specifically required by a contract" to mean that: (1) the effort is not specifically required by the contract's SOW or other term or specifically included in the contract's price or cost build-up in support of the price; and (2) there is a reasonable expectation at the time the R&D effort begins that the effort will benefit more than one contract. This last point regarding benefit to more than one contract means exactly that, and *not* benefit to more than one "program" or more than one "buyer."

Consistent with this clarification from the Federal Circuit, contractors should consider whether their disclosed cost accounting practices are compliant with the requirements of CAS 420 and CAS 402. Specifically, contractors should consider whether R&D costs incurred in like circumstances for the same purpose are consistently classified as either direct or indirect costs. Further, in determining whether R&D costs qualify as IR&D costs, contractors should consider the circumstances and purpose of the R&D effort and how those circumstances are addressed in their CAS Disclosure Statements.

Contractors should also take heed that the facts and circumstances relating to a contract will continue to be relevant, and carefully consider the facts relating to any contract that might arguably specifically require R&D effort to ensure that the determination made regarding classification of the related costs as IR&D costs is appropriate and consistent with disclosed cost accounting practices. Facts relevant to this inquiry may include: (1) the parties' intent, as shown by proposals, negotiation documentation, and internal documentation regarding contract negotiation; (2) the wording of the contract; (3) the contract's cost estimates and actual costs; and (4) work delineations (i.e., drawings, outlines, and portrayals). Finally, facts supporting the existence of a reasonable expectation of multiple contracts for the product (multiple sales) remain important, and there should be documents created contemporaneous to the decision to perform the R&D effort that support the basis for a multiple benefit.

In addition to the above, the Federal Circuit's decision confirms that "parallel" or "generic" IR&D remains appropriate. That is, the decision permits contractors to engage in R&D effort to support ongoing contract work and to classify the resulting costs as IR&D costs so long as the support just described exists. The Federal Circuit's decision also means that contractors may use ongoing IR&D effort to support a contract that is to be performed in the future. For example, contractors can perform R&D to generate "branch technologies" that will be used to perform a contract being negotiated or that are likely to support other future contracts. Thus, these types of R&D efforts result in IR&D costs so long as contractors appropriately negotiate and draft contracts and the costs are properly considered IR&D costs under disclosed cost accounting practices that are followed consistently.

Next, the Federal Circuit's decision emphasizes consistent treatment of IR&D and B&P costs. For accounting purposes, B&P costs are subject to the same rules as IR&D costs. Indeed, the Federal Circuit's decision is based on its recognition that CAS 402 Interpretation No. 1 and other interpretations of B&P costs govern both IR&D and B&P costs. The court's decision regarding how to determine when R&D effort is "required in the performance of a contract," therefore, applies equally to determining when the costs of B&P efforts may be properly treated as indirect B&P costs. Contractors should therefore consider whether their cost

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accounting practices apply the same standard to determine both IR&D and B&P costs, as different standards might result in disapproved costs and accounting practices.

The Federal Circuit's decision in *ATK* also establishes certain "best practices" for cost accounting. The court held that contractors have "considerable freedom" in selecting their disclosed accounting practices,[20] and further recognized that contractors' primary means for establishing these practices is through their CAS Disclosure Statements.

This aspect of the decision is very important. The court's reaffirmation that contractors have broad discretion to select proper cost accounting practices provides contractors a strong basis to dispute government contentions that a contractor's accounting practice is "not acceptable" or not the best practice and needs to be changed even when the practice is CAS compliant. Lately the Defense Contract Audit Agency (DCAA) is increasingly raising such contentions regarding contractor accounting practices. As a counterbalance to this trend, the Federal Circuit's decision in *ATK* establishes that disclosed and approved accounting practices are acceptable and binding on contractors and the government alike, absent noncompliance with an enumerated CAS requirement.

Thus, contractors should demand government compensation for any change in practice, absent an established CAS noncompliance. Further, when the government coerces a change by, for example, disapproving of a contractor's accounting system because an accounting practice creates a deficiency, contractors should acquiesce only after reserving their rights to be compensated for a contract change or breach of contract.

Although the Federal Circuit in *ATK* did not directly address technical data rights, an important impact of the court's decision is that it ensures continued consistency between cost accounting and data rights regulations. This consistency provides additional legal support for the court's determination that R&D is not "required in the performance of a contract" under CAS 420 and FAR § 31.205-18 merely because the effort is "necessary" or "implicitly required" for contract performance.

Specifically, technical data rights regulations permit contractors to classify R&D effort necessary to or impliedly required by a contract as IR&D so long as no contract specifically requires the effort. In fact, in 1995, Department of Defense (DoD) regulators addressing the data rights regulations specifically rejected government arguments that "necessary" effort (an effort performed during contract performance that "relates" to a contract) is "required" effort that results in direct costs and government data rights.

For background, prior to 1985, the DoD's technical data rights provisions stated that a contractor owned the rights to technical data if the data were "developed exclusively at private expense."[21] Private expense meant, and still includes, indirect costs including IR&D. For example, in *Bell Helicopter Textron*,[22] the Armed Services Board of Contract Appeals (ASBCA) held that technical data generated from R&D efforts not specified as an element of contract performance were developed at private expense even though the effort was clearly "necessary" for contract performance.

Indeed, *Bell Helicopter* recognized that a contractor and the government have discretion to agree upon whether to include development effort necessary to perform a contract as a specific element of the contract in order to negotiate an acceptable allocation of rights in technical data. The ASBCA stated:

> If Hughes wished to preserve complete limited rights protection of the launcher interface, it should have reached agreement with the Government for continued company funding of the further development work on the interface.[23]

Notably, the COFC in its *ATK* decision similarly recognized the discretion that the government and contractors have to include R&D effort as a specific contract requirement.

The *Bell Helicopter* decision (and several congressional mandates requiring that the DoD clarify its regulatory coverage regarding technical data rights) resulted in DoD's issuing the 1988 Technical Data Regulations, which provided:

> Developed exclusively at private expense means, in connection with an item, component or process, that no part of the cost of development was paid for by the Government and that the development was not required for the performance of a Government contract or subcontract. Independent research and development and bid and proposal costs, as defined in FAR § 31.205-18 (whether or not included in a formal [IR&D] program) are considered to be at private expense. All other indirect costs of development are considered Government funded when development was required for the performance of a Government contract or subcontract. Indirect costs are considered funded at private expense when development was not required for the performance of a government contract or subcontract."[24]

Further, in these regulations, the term "required for the performance of a Government contract or subcontract" was defined to mean that

> the development was specified in a Government contract or subcontract or that the development was accomplished during and was *necessary for the performance of a government contract or subcontract*."[25]

A groundswell of dissatisfaction with the 1988 Technical Data Regulations prompted a congressional directive to review data rights issues using a "Joint Committee" of government and contractor representatives. The Joint Committee focused on, among other things, whether the 1988 Technical Data Regulations were being used to acquire rights in technical data for the government because data were developed "during and was [sic] necessary for performance" even though the data, in fact, had been developed at private expense (as defined in the regulations to include IR&D).

The Joint Committee ultimately concluded that the government did not need to use the "during and was nec-

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essary for" concept. Rather, compliance with the CAS and FAR definitions of direct and indirect costs assured that the government and contractors received appropriate rights in technical data. The Joint Committee's recommendation to the DoD regulators explained:

> Developers' representatives identified the "required for performance" criterion as one of the more onerous aspects of the existing regulations. They suggested that the criterion was inconsistent with statutory requirements by permitting the government to claim unlimited rights in data pertaining to an item or process developed at private expense when development was accomplished concurrent with performance of a government contract and not expressly called for by the contract.[26]

Thus, the Joint Committee was satisfied that the appropriate mechanisms for distinguishing "direct" government-funded contract R&D effort from "indirect" IR&D are CAS and FAR provisions, contractors' disclosed cost accounting practices, and contractors' obligations to consistently apply these practices.

Responding to the Joint Committee's recommendation, the DoD in its final rule issued June 28, 1995, eliminated the 1988 Technical Data Regulations' "during" and "necessary" criteria and the definition in those regulations of "required for the performance of a Government contract or subcontract."[27] The DoD explained this change, stating:

> DOD believes [the "required for performance"] criterion should be eliminated to protect private expense development, encourage developers of new technologies or products, many of whom are small businesses, to offer their products to the Government, encourage dual use development, and balance the interests of data users and data developers.[28]

When adopting the final rule, therefore, the DoD clarified that, under technical data regulations, a government contract does not specifically require R&D effort when that effort is only "necessary" to contract performance. This conclusion bears a striking resemblance to the Federal Circuit's statement regarding the fundamental policy underlying IR&D effort. In short, the Federal Circuit's holding in *ATK* is fortunate. If the court had adopted the "necessary" or "implicitly required" standard followed in *Newport News* and similar cases, the current data rights regime would have been turned upside down.

Implementing Guidance

The Federal Circuit's *ATK* decision provides much needed guidance to contractors seeking recovery of IR&D costs. To implement this guidance, contractors should consider:

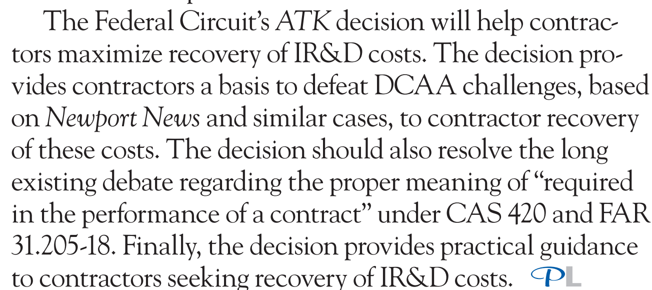
• Examining their cost accounting practices, CAS Disclosure Statements, and related policies and procedures to ensure that IR&D cost allowability is maximized;

• Ensuring that their contract pricing and negotiation policies and procedures, as well as standard terms and conditions and SOWs, for both government and commercial contracts, establish a clear statement of intent in the contract language regarding what R&D effort is specifically required by a particular contract;

• Drafting IR&D project descriptions to demonstrate that the project will benefit multiple contracts; and

• Preparing IR&D project delineations to show no specific contract requirement.

The Federal Circuit's *ATK* decision will help contractors maximize recovery of IR&D costs. The decision provides contractors a basis to defeat DCAA challenges, based on *Newport News* and similar cases, to contractor recovery of these costs. The decision should also resolve the long existing debate regarding the proper meaning of "required in the performance of a contract" under CAS 420 and FAR 31.205-18. Finally, the decision provides practical guidance to contractors seeking recovery of IR&D costs. PL



Endnotes

1. 598 F.3d 1329 (Fed. Cir. 2010).
2. 68 Fed. Cl. 612 (2005).
3. *See* United States v. Newport News Shipbuilding, Inc., 276 F. Supp. 2d 539 (E.D. Va. 2003); United States *ex rel*. Mayman v. Martin Marietta Corp., 894 F. Supp. 218 (D. Md. 1995); *see also* TRW Inc., ASBCA Nos. 51171, 51530, 01-1 BCA ¶ 31,390.
4. 48 C.F.R. § 9904.402-40.
5. 48 C.F.R. § 9904.402-30(a)(3).
6. 48 C.F.R. § 9904.402-30(a)(5).
7. 41 Fed. Reg. 24,691 (June 18, 1976).
8. 862 F.2d 290 (Fed. Cir. 1988).
9. Before both the COFC and the Federal Circuit, the government argued that the negotiations between ATK and Mitsubishi were improperly designed to shift the upgrade costs to the government. Both the COFC and the Federal Circuit rejected this argument. Both courts found nothing objectionable in the parties' agreement to exclude the Castor IV upgrade costs from the Mitsubishi contract or ATK's decision to charge the costs as IR&D costs.
10. *ATK*, 598 F.3d at 1331.
11. The government also cited *Mayman*, 894 F. Supp. at 221-23, to support its argument that the Castor IV upgrade effort was "required in the performance of" the Mitsubishi contract because ATK could not meet the contract's requirement to provide Mitsubishi an upgraded motor without first performing the upgrade effort.
12. *ATK*, 598 F.3d at 1333.
13. *Id.* at 1333-34.
14. *Id.* at 1334-35 (explaining that "we agree with the trial court and ATK that the meaning of [the limiting phrase] in the definition of IR&D must be the same as the meaning of the identical phrase in the definition of [B&P] costs").
15. 48 C.F.R. § 9904.402-61(c) (emphasis added).
16. *ATK*, 598 F.3d at 1335.
17. *Id.*
18. *Id.* at 1335-36.
19. *Id.* at 1335.
20. *Id.* at 1332.
21. 10 U.S.C. § 2320.
22. Bell Helicopter Textron, ASBCA No. 21192, 85-3 BCA ¶ 18,415.
23. *Id.*
24. DoD FAR Supplement (DFARS) 227.401(12), 252.227-7013(a)(12) (1988) (emphasis added).
25. DFARS 227.401(16), 252.227-7013(a)(16) (1988) (emphasis added).
26. Tab 33, at 00616-17 (Memorandum for the Secretary of Defense, re: Recommended Technical Data Regulations (March 24, 1994)).
27. DFARS 252.227-7013(a)(7).
28. 60 Fed. Reg. 33,464 (June 28, 1995) (emphasis added).

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