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Posted at 4:16 AM on April 14, 2010 by Sheppard Mullin

Court of Appeals Finds That R&D Costs Not Explicitly Required By A Contract Qualify As IR&D

By Anne B. Perry

A controversy with a more than 35 year life has finally been addressed by the US Court of Appeals for the Federal Circuit – and in a pro-contractor fashion. In its March 19, 2010 decision in *ATK Thiokol, Inc. vs. United States*, Fed. Cir. No. 2009-5036 (3/19/10), the Court of Appeals, in affirming the Court of Federal Claims decision from 2005, determined that research and development costs not *specifically* required by a contract may be treated as Independent Research and Development ("IR&D") under FAR 31.205-18. While this might seem a fairly unremarkable holding, and one consistent with reason, sound procurement policy, and a harmonious reading of the relevant regulations, the Government has for years taken the contrary view that costs of *implicitly* required development cannot be treated as IR&D. And, as a result, those contractors who treated such costs as IR&D have been treated to cost disallowances, citations for CAS non-compliance, and even accusations of fraud.

ATK Thiokol's IR&D controversy itself has a long history. The costs at issue were actually incurred a lucky 13 years ago in 1997 in upgrading its Castor IVA-XL motor. Before undertaking the modifications, ATK marketed these motors to a variety of domestic and foreign entities and, in June 1997, entered into an agreed statement of work with Mitsubishi Heavy Industries for an upgraded motor for Japanese launch vehicles. Mitsubishi, however, specifically rejected accepting financial responsibility for the costs of upgrading the motors, the contract requiring only delivery of motors meeting upgraded performance parameters. ATK then undertook the following month, in July 1997, to upgrade the design of the motor and to test fire the new design, charging the costs as IR&D. Two years later, the DoD Divisional Administrative Contracting Officer ("DACO") issued a notice of intent to disallow the costs, asserting that the costs to upgrade the motor were "required in the performance of a contract" and thus (a) fell within exclusion from IR&D under FAR 31.205-18, and (b) were properly allocable directly to the Mitsubishi contract. The fact that the Mitsubishi contract excluded the costs for development effort and that the upgraded motor was being marketed to multiple customers – both Government and commercial – was of no consequence to the DACO.

ATK first challenged this disallowance in the Court of Federal Claims, and the Court sided with ATK. Finding that the costs were properly treated as IR&D, the COFC held that: "ATK and

Mitsubishi did not intend to include the Development Effort costs among the costs paid for under the contract, that the commercial market for the upgraded Castor motor appeared viable, that the allocation of the Development Effort costs to indirect IR&D was in accordance with ATK's disclosed accounting practices, and that the government had not contended that the Development Effort costs were unreasonable." ATK Thiokol, Inc. v. United States, 68 Fed. Cl. 612, 640-41 (2005).

Sensing that its prior success in disallowing such costs might soon be relegated to the mists of history, the Government appealed the COFC's decision. But to no avail.

First, the Court of Appeals disposed of the Government's argument that the costs should be treated as "direct" under CAS 402, finding that the development (1) was "not specifically required by the Mitsubishi contract," (2) "had a reasonably foreseeable benefit to more than one contract," and (3) had been treated as indirect costs consistent with ATK's disclosed and established practices.

Next, the Court had to determine whether, as indirect costs, they were properly treated as IR&D. The key inquiry was what FAR 31.205-18 means by the sentence "[t]he term does not include the costs of effort … required in the performance of the contract" as a basis of excluding effort from the definition of IR&D. Substantially identical language is found in CAS 420-30(a)(6).

The Government contended that the phrase meant that "IR&D costs do not include the costs of efforts that are either explicitly ***or implicitly*** required in order to complete a contract." (Emphasis added). According to the Government, since ATK could not provide upgraded motors without first performing the research and development effort, those costs were, at a minimum, ***implicitly*** required by the Mitsubishi contract and thus could not qualify as IR&D. In arguing for this broad definition, the Government relied on an Eastern District of VA decision in a False Claims Act case, *United States v. Newport News Shipbuilding, Inc.*, 276 F. Supp. 2d 539 (E.D. VA 2003), in which the Court essentially agreed with this expansive Government interpretation. The Government further contended that its interpretation was consistent with "sound procurement policy," because "allowing a government contractor to charge an indirect IR&D account for those research costs that are necessary to complete a commercial contract but not paid for in that contract will invite a contractor to 'game the system' by shifting commercial contract cost to the government."

ATK, on the other hand, contended that the phrase "required in the performance of the contract," means only those efforts that are "explicitly required by the contract," such that any effort not expressly required by the terms of the contract and for which the contract offers no reimbursement could properly be treated as IR&D. This, argued ATK, was consistent with the definition of Bid and Proposal ("B&P") costs, which is also found in FAR 31.205-18 and uses the exact same "required in the performance of the contract" exclusionary language.

In analyzing the issue, the Court looked to the plain language of the regulation and to its history. The Court of Appeals found both to be ambiguous, citing and quoting our own John W. Chierichella from his article, IR&D v. Contract Effort, in 90-2 Gov't Contracts Cost, Pricing &

Accounting Report 8 (Feb. 1990), in which Mr. Chierichella had noted the "'sustained intra-Governmental debate and confusion' over whether research and development effort not specified or directly funded by a contract may be disallowed as IR&D because it is deemed 'implicitly' necessary."

Ultimately, however, the Court found the B&P language of FAR 31.205-18 to be instructive. Looking to an "Interpretation" of CAS 402, the Court acknowledged that the CAS recognized a distinction between B&P costs that were required by, and thus relate only to, one contract and those that "relate to all work of the contractor." The Court found that "[t]he 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.'"

Noting that both the definition of B&P and IR&D within the same FAR provision have the identical exclusionary phrase of "required in the performance of the contract," the Court could find absolutely no legal or logical support for the Government's contention that identical language in the same regulatory provision should be interpreted differently. Thus, the Court of Appeals agreed with the COFC's determination that "the meaning of that phrase in the definition of IR&D must be the same as the meaning of the identical phrase in the definition of bid and proposal ("B&P") costs."

Rejecting the Government's policy argument for applying two separate definitions, the Court noted that IR&D's purpose was to encourage contractors to innovate and "maintain a high level of technological sophistication, and ultimately to improve the products it offers to the government." Moreover, it found that applying the Government's definition "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, whether the contract is governmental or commercial," an allocation method that the Court concluded "is not sensible as a policy matter," a perversity first noted by the ASBCA in its 1966 decision in *General Dynamics Corp.,* ASBCA No. 10254, 66-1 BCA ¶ 5680.

Now that the Government has been told that its interpretation has been incorrect, do we expect that the Government will repay all of the contractors for whom it has disallowed these costs? Should contractors wrongly accused of fraud expect an apology? “Lotsa luck.” In fact, it won’t be a surprise if the Government, instead of applying this correct definition, modifies the regulations to disallow both B&P and IR&D when they are "implicitly" required by a contract. An unfair result to be sure, and one that will stultify technological initiative for sure, but not an unlikely outcome.

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