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The Times They Are A Changin' - Independent Research and Development May Not Be So "Independent" Any More

By David S. Gallacher

Those familiar with Government contracting know at least a little bit about the elusive and fickle regulatory requirements for Independent Research and Development ("IR&D" or "IRAD") costs. IR&D is a means by which the U.S. Government supports a Contractor's independent R&D efforts. By reimbursing a Contractor's independent R&D costs, the Government long has hoped to advance the state of the art without stifling a contractor's innovation under the weight of a federal bureaucracy, while simultaneously banking on the fact that the U.S. Government also will benefit from the technology advancements. But two recent developments may change the essential nature of IR&D, making it less "independent" and more "dependent" on Government rights and oversight. To quote Bob Dylan – "the times they are a changin'."

Background on IR&D

We previously have discussed the slippery and elusive nature of IR&D in this blog (click here and here). IR&D (as well as its sister-category of costs, Bid and Proposal ("B&P") costs) have been defined by regulation for more than 50 years (currently at FAR 31.205-18). At its core, FAR 31.205-18 allows companies to engage in R&D effort independent of a particular contract or customer, with the Government agreeing to reimburse all reasonable, allowable, and allocable independent R&D costs. Historically, the technology was considered "developed exclusive at private expense" even though it ultimately was reimbursed by the Government as an indirect cost, because the R&D was done independent of any particular contract. The Government hoped that the "independence" of the R&D would help incentivize a Contractor to develop new technologies, where it would be able to reap the full benefit of its innovation without signing away the rights to the Government. Consequently, the Government gained no specific rights in the developed technology.

New 2011 Defense Authorization Act

Congress recently has modified the essentially "independent" character of IR&D funds –

allowing Government rights and Contractor rights to be intertwined more fully. Section 824(b) of the 2011 National Defense Authorization Act (Pub. L. No. 111-383) amends 10 U.S.C. § 2320(a)(3) and can be read to require that items, components, or processes developed under IR&D activities be considered to have been "developed exclusively with Federal funds" for purposes of giving the U.S. Government unlimited rights in the developed data. Numerous industry groups working through the Acquisition Reform Working Group have criticized this provision as being overly broad, as well as representing a radical shift in Department of Defense ("DoD") procurement policy. While the new statutory language is ambiguous as written, the change would seem to convert: (a) DoD IR&D-funded activities (even, potentially, projects with mixed funding from both IR&D and purely private sources), which previously were treated as "developed exclusively at private expense" and which subsequently were provided to the U.S. Government under limited rights, into (b) fully Government-funded R&D projects, in which the Government would obtain unlimited rights. While the DoD no doubt will issue new regulations implementing this new statutory requirement (with a new DFARS case opened on January 19, 2011), the fact remains that the fundamental nature of IR&D costs may have changed radically as of January 7, 2011, the date on which Section 824 went into effect.

The potential impacts of changes under Section 824 are also discussed in greater detail here.

Proposed DFARS Rule

Beyond the Section 824 statutory change to the essential nature of IR&D funding, DoD also has proposed "a changin'" a rule that would tie recoverability of IR&D costs to a new reporting requirement. On March 2, 2011, DoD published a proposed rule that would require contractors to report IR&D projects generating annual costs of more than $50,000 as a condition for allowability. *See* 76 Fed. Reg. 11414. DoD is accepting comments through May 2, 2011.

The proposed rule would impose an additional recovery requirement for "major contractors" – contractors allocating to the Government more than $11 million in IR&D and B&P costs in the preceding fiscal year. Back in the early-1990s, DoD used to place express caps on IR&D to limit a Contractor's recovery. However, since the late-1990s, DoD lifted the IR&D caps (allowing recovery so long as the costs are reasonable and allocable), and imposed extra scrutiny only on "major contractors," which are required to demonstrate that the incurred IR&D costs are for projects "that are of potential interest to DoD." The latest proposed rule was prompted because DoD feels that it has lost the "linkage between funding and technological purpose," causing DoD to scrutinize IR&D projects more closely. The proposed rule would require all major contractors generating more than $50,000 annually in IR&D costs to submit annual reports on each IR&D project (with updates at the conclusion of the project).

In many respects, this new reporting requirement may seem largely unremarkable. After all, most major contractors long have been willing to give DoD greater visibility into their

IR&D processes, and major contractors routinely publish internal IR&D reports tracking the progress of the projects. Where is the harm in submitting a series of extra forms to the Government (particularly where those forms may be rather brief)? But, as often is the case, the true questions under this proposed rule relate to what the rule does **not** say. In particular, the proposed rule is silent on five key issues.

1. **To Whom Would the Reporting Requirement Apply?** Since the new proposed rule is buried in the DFARS under a sub-sub-section relating to "major contractors," does that mean that non-"major contractors" will continue to operate under the status quo with recoverability of IR&D costs limited to the reasonability and allocability of the costs, without additional reporting? Considering that "major contractors" are, by definition, contractors with more than $11 million in IR&D and B&P costs, it is unclear whether the much-much lower $50,000 threshold is designed to apply universally to **all** types of contractors ("major" and "non-major" alike), or simply to the subset of "major contractors" with more than $11 million in total IR&D/B&P costs. Or, alternatively, does the reporting requirement apply only to projects generating at least $50,000, for all "major contractors" with more than $11 million total in annual IR&D & B&P? Without explanation, the differing dollar thresholds confuse the issue.

2. **What Kinds of Information Should These Reports Include?** The proposed rule estimates that only 30 minutes will be required for each submission, so one cannot help but wonder whether these new required reports truly will provide substantive information that will provide DoD with improved visibility into the technology development, or whether it simply will provide DoD with a flood of perfunctory and imprecise technical "headlines." How useful will these reports be, in reality?

3. **How Would Proprietary Information be Handled?** Given the cutting-edge nature of many IR&D projects, most companies would be loathe to pre-publish any details about its R&D where there are risks that this information may be released publicly, even if the information submitted is very high-level. Especially given that questions have been raised about the adequacy of the existing Defense Technical Information Center ("DTIC") database to protect proprietary concerns, one cannot help but wonder how carefully these reports will be held. Clarity from DoD on how the information contained in these reports would be handled would be greatly appreciated.

4. **How Should Classified Information be Handled?** What should a contractor do when its project involves classified information? Could the failure to report on the progress of classified IR&D programs affect a contractor's ability to recover those IR&D costs? Intuitively, one would think that national security considerations would and should override such administrative requirements. But that may offer little solace for contractors forced to explain themselves to the relentless and unyielding Defense Contract Audit Agency ("DCAA") who would argue that the

failure to submit a report impacts the allowability of the costs.

5. **What Role Would the DCAA Play in "Evaluating" The Reports?** The proposed rule states that the reports should be submitted to DTIC via their website and to the DCAA (to support the costs), but that the Administrative Contracting Officer ("ACO") will continue to have authority in determining what projects are of potential interest to DoD. However, where DCAA has a say as to whether the costs are allowable or not, we would not be surprised to find DCAA overstepping its authority, holding itself out as a technical expert, and passing judgment on the desirability of a given project. Where DCAA has a long history of being inconsistent and overreaching (a history discussed extensively on our blog here, here, here, here, and here), one cannot help but wonder if a DCAA auditor might view higher dollar IR&D projects as "less important" to the DoD's interests, simply so that DoD will not have to pay for such costs. To quote Kurt Cobain, "Just because you're paranoid, doesn't mean they're not after you."

Conclusion

Given the fundamental shift on IR&D costs in the 2011 DoD Authorization Act, the change to the essential nature of IR&D funding already may have arrived. For IR&D, the times may not simply be "a changin'" (*present tense*); they may have already "a changed" (*past tense*). The new proposed DFARS rule simply may be a symptom of this change, with increased scrutiny by all parties within DoD (COs, auditors, and technical fellows) on whether your IR&D is truly "worth it" or not. For IR&D, this may be "new normal."

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