

# THE GOVERNMENT CONTRACTOR<sup>®</sup>



Information and Analysis on Legal Aspects of Procurement

Vol. 48, No. 2

January 18, 2006

## ***Focus***

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### **FEATURE COMMENT: Decision On Accounting For IR&D Costs Has Important Implications For Intellectual Property Rights Of Government Contractors**

A recent decision by the Court of Federal Claims on the allocation of independent research and development (IR&D) costs could have important implications for intellectual property rights of Government contractors, as well as their ability to recover development expenditures as indirect costs. *ATK Thiokol, Inc. v. U.S.*, 68 Fed. Cl. 612 (2005). The Court, in essence, concluded that the company had flexibility to treat development costs for a rocket motor as IR&D and to account for them as indirect costs—a portion of which was reimbursed by the Government as overhead under cost-type contracts—although the development was necessary for the company to perform a commercial contract. Contractors' ability to benefit from this holding will depend on defining appropriate accounting policies and applying them consistently.

IR&D comprises research efforts that a company undertakes on its own, rather than as part of work performed under a contract, grant or other funding agreement with a third party. Such efforts typically benefit more than one cost objective and are accounted for as indirect costs. Companies that have cost-reimbursement Government contracts can recover an allocable portion of IR&D costs as indirect costs under those Government contracts.

Classification of development costs as IR&D is also critically important for IP rights. Government rights in technical data turn on whether development occurred at Government expense. If so, the Government would normally obtain "unlimited

rights" in the data. However, IR&D costs are treated as a "private expense" and do not give rise to a Government license, even if a portion may be reimbursed by the Government as indirect costs. Similarly, Government patent rights turn on whether the conception or first actual reduction to practice occurred "in performance of" a Government contract. If so, the Government obtains a perpetual, worldwide, royalty-free license to practice the invention by or on behalf of the Government. If a research effort is properly classified as IR&D, any inventions arising from it would not be "subject inventions" in which the Government obtains a license, notwithstanding some federal subsidy of the research cost.

ATK Thiokol had a commercial contract to supply Mitsubishi Heavy Industries with an upgraded launch vehicle for use in Japan's space program. That contract did not specify a development effort, nor did the pricing breakdown specify development costs. However, because the upgraded vehicle had not previously been produced, development was necessary to deliver what the contract required. Thiokol conducted the upgrade as an IR&D effort and accounted for it as an indirect cost. This accorded with Thiokol's accounting practices, which required treatment as a direct cost of a contract only if (1) the contract specifically requires the cost; (2) the contract pays for the cost; or (3) at the time the cost is incurred, there is no foreseeable benefit to more than one cost objective. Thiokol expected that the upgraded technology could be marketed to customers other than Mitsubishi. The Government was thus charged over \$3 million of the IR&D effort through indirect cost pools.

The Government sought to disallow those costs, arguing that such an allocation violated Cost Accounting Standard 420 and cost principle 18, which do not allow indirect charging of a cost "required in performance of a contract." According to the Government, since the Mitsubishi contract made the launch vehicle upgrade a "practical necessity," the development work could be charged only as a direct cost of that contract.

The Court rejected this view, holding instead that what was “in performance of the contract” was to be determined by the intent of the parties to that contract. The reliance on the parties’ express intent in turn implies that this type of cost is one for which there may be more than one valid cost treatment. Which one is correct in a particular instance depends on the accounting practices that the company has adopted and the expression of the contract parties’ intent, i.e., the explicit terms of the contract that is alleged to necessitate the development work.

From the Government’s perspective, the Court’s interpretation might be viewed as a loophole that allows a contractor to circumvent the intent of the applicable CAS and cost principle. But from another point of view, supply contracts for the delivery of technology generally are not considered to include development even though (a) the prior development of the technology is a “practical necessity” and (b) companies typically recoup (or attempt to recoup) their R&D investments through the sale of the resulting products. From this perspective, a development project like that in *Thiokol* should not have to be accounted for differently just because it occurs immediately prior to or after the award of a customer contract to deliver the end product.

While the *Thiokol* case involved development alleged to have occurred under a commercial contract, the same analysis of “in performance” would apply in the case of a Government contract. In such a case, the Government would not have a cost incentive to argue that development was “required in performance,” since a direct allocation to the contract would result in a greater cost to the Government than an IR&D allocation. But if the issue were technical data or patent rights, the Government would stand to gain a royalty-free, worldwide license if the development were determined to be “in performance.” Conceptually, this intellectual property question is distinct from the cost recovery issue in the *Thiokol* case. However, there is no apparent reason for the analysis or result to differ in the two types of cases. Both ultimately turn on whether the work in question was in performance of a contract.

The *Thiokol* decision is an important precedent that technology developers involved in both commercial and Government markets can use to their advantage. In some circumstances, more than one type of cost allocation for development work is possible. The preferred approach must be identified, taking into ac-

count both cost recovery and IP consequences. A company should have appropriate written allocation policies (which must be included in its CAS disclosure statement if the contractor is subject to CAS). Those policies should make it clear that an indirect IR&D allocation is appropriate if development is not an explicit part of a contract scope of work and the work may ultimately benefit more than one project or customer—even if there is only one firm customer when the development begins. If in a particular instance an indirect allocation is desired and possible, great care must be taken to ensure that the contract SOW and other terms use the language of “supply,” and not that of “development.”



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