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# PROBLEMS ABOUND WITH DOD'S PROPOSED IRAD RULE

By: David Churchill

On November 4, 2016, the Department of Defense proposed a new rule (https://www.gpo.gov/fdsys/pkg/FR-2016-11-04/pdf/2016-26369.pdf) applicable to major defense contractors who expect to use future independent research and development ("IRAD") to perform DoD contracts. The proposed rule requires DoD agencies to assign an evaluation cost penalty to the proposed price of any contractor expecting to receive reimbursement from the United States Government for any future IRAD expenses through its indirect cost rates. Comments on the proposed rule were due on Friday, February 2, 2017. For the reasons described in this entry, we think this rule is illogical and misguided, and we hope the DoD will retract the rule or substantially revise it as a result of the comments it receives.

The proposed rule is antithetical to policy considerations favoring IRAD as a valid and valuable component of a contractor's indirect costs, purposes strongly endorsed by Congress recently in the National Defense Authorization Act of 2017 ("2017 NDAA") enacted on December 23,

2016. The proposed rule also would add more complexity to a proposal evaluation process already freighted with rules intended to further social policy goals – sometimes at the expense of rational, price-based proposal evaluation.

**I. The proposed rule**

On April 9, 2015, DoD issued its "Implementation Directive" for Better Buying Power 3.0 initiative (the "Implementation Directive"). In a section of the Implementation Guidelines (Attachment 2 to the Implementation Directive) addressing IRAD, DoD noted that:

> [A] high fraction of IRAD is being spent on near-term competitive opportunities and on de minimis investments primarily intended to create intellectual property. A problematic form of this use of IRAD is in cases where promised future IRAD expenditures are used to substantially reduce the bid price on competitive procurements. In these cases, development price proposals are reduced by using a separate source of government funding (allowable IRAD overhead expenses spread across the total business) to gain a price advantage in a specific competitive bid. This is not the intended purpose of making IRAD an allowable cost.

Implementation Guidelines at 11-12. DoD further explains:

> The intent of the [specific actions with respect to IRAD] below is to ensure that IRAD meets the complementary goals of providing defense companies an opportunity to exercise independent judgement on investments in promising technologies that will provide a competitive advantage, including the creation of intellectual property, while at the same time pursuing technologies that may improve the military capability of the United States. The laissez faire approach of the last few decades has allowed defense companies to emphasize the former much more than the latter. The goal of this initiative is to restore the balance between these goals.

Implementation Guidelines at 12.

The proposed rule turns away from what DoD termed "the laissez faire" approach. The rule's objective, DoD notes, is to ensure contractors are penalized for reducing their proposed price in reliance on government funding of future IRAD projects through indirect cost rates. 81 FR 78014 (Nov. 4, 2016). The proposed rule would add a new DFARS 215.305 (a) (1):

> [W]hen an offeror proposes a cost or price that is reduced due to reliance upon future Government-reimbursed independent research and development projects, the contracting officer shall, for evaluation purposes only, adjust the total evaluated cost or price of the proposal to include the amount by which such investments reduce the price of the proposal.

To determine whether the proposed cost or price has been "reduced due to reliance upon future Government-reimbursed [IRAD] projects," the proposed new solicitation clause at DFARS 252.215-408 (2) requires the offeror to include the following documentation in its proposal:

> If the Offeror, in the performance of any contract resulting from this solicitation, intends to use IR&D to meet the contract requirements, the Offeror's proposal shall include documentation in its price proposal to support this proposed approach.

**II. The proposed rule will create confusion about whether the IRAD projects identified by the offeror are truly "independent."**

The rule requires the offeror to state in its proposal if it intends to use any IRAD projects to "meet the contract requirements." This obligation is the "elephant in the room," posing a conundrum the proposed rule itself makes no effort to resolve: projects for basic research, applied research, development, or systems and concept formulation cannot be "independent" if they were "required in the performance of a contract," FAR 31.205-18 (a), definition of Independent Research and Development,[1] yet the required self-identification assumes a research project can be both "required" by the contract and "independent."

The FAR exclusion of any costs for projects "required in the performance of a contract" from the category of "independent" research and development has sparked disputes between the Government and its contractors for decades. The Government has argued that research, development, or bid and proposal efforts "***implicitly*** required" for successful performance of a contract cannot be independent. Contractors have argued that the restriction applies only to effort that is "***specifically required***" by the terms of a contract. Decisions see-sawed back and forth on the issue,[2] until the Court of Appeals for the Federal Circuit determined – finally, it appears – that the reference in both the B&P and IRAD cost principles to work "required in the performance of a contract" means "costs that are specifically required by the contract." *ATK Thiokol, Inc., v. United States*, 598 F.3d 1329, 1335 (Fed. Cir. 2010).

The language used in the proposed regulation threatens to incite a new debate over what work is "required in the performance" of a contract. The identification of work as "intended to meet the contract requirements" comes perilously close to constituting an admission that the work is "specifically required in the performance of" the contract. The Government seems to be

requiring offerors to admit that any projects they self-identify under this provision cannot be deemed "independent," while implicitly promising at the same time to treat them as though they were.

At a minimum, the regulation should be revised to clarify that this self-identification of IRAD projects does not mean the projects are "required in the performance of" the contract and will not disqualify the projects from being treated as IRAD in the future.

**III. Public policy has long favored rewarding, rather than penalizing, private company investment in research and development, and Congress strongly endorsed that policy in the 2017 NDAA. The proposed rule is antithetical to Congress' expressed intent.**

The DoD's expressed intent, implemented in the proposed rule, is to end the "laissez faire" approach and, by regulation, ensure what it considers to be an appropriate "balance" between the technologies it wants industry to pursue and those "near term competitive opportunities" and "de minimis investments primarily intended to create intellectual property" that it wants to discourage. By proposing to impose an evaluation penalty on company IRAD projects that constitute types of IRAD it disfavors, DoD threatens to undermine Congressional intent.

The Government has long recognized that independent research and development efforts undertaken by industry have provided enormous benefits to the country, sometimes in unexpected ways. As one commentator notes, "The continued economic prosperity and national security of the United States is directly tied to its R&D commitment. Paying for R&D costs, through the IR&D cost principle, lies at the heart of R&D policy." Mark J. Nackman, *Implicit Versus Explicit Requirements and Independent Research and Development Costs under ATK Thiokol: Securing the Future of U.S. Technology Investment*, 41 Pub. K. L. J. 2 (Winter 2012) at 337-38.

IRAD is recognized as a key to technological innovation by American industry involved in the defense business. Accordingly, regulations governing IRAD costs have continually liberalized recoverability of these costs, moving away from government oversight and caps on reimbursement. *Id.* at 301-312 (history of the IRAD cost principle). Since 1993, Congress has required that "Regulations prescribed [by the DoD with respect to IRAD recoverability] may not include provisions that would infringe on the independence of a contractor to choose which technologies to pursue in its independent research and development." 10 U.S.C. § 2372 (f). Subject to that limitation, the DoD is allowed to limit allowable IRAD to "work which the Secretary of Defense determines is of potential interest to the Department of Defense." 10 U.S.C. § 2372 (c) (1). IRAD costs are stated to be allowable to the extent they are "allocable,

and reasonable, and not otherwise unallowable by law or under the Federal Acquisition Regulation." 10 U.S.C. § 2372 (b). Thus, the present law has both promoted IRAD recoverability and restricted the DoD's ability to infringe on contractors' independence in determining which IRAD projects to pursue.

The 2017 NDAA, effective in October 2017, goes further on each of these fronts. First, leaving in place the prohibition on DoD making any regulation that would infringe on the contractor's independence to select its IRAD projects, it removes the statement that allowable IRAD is limited to "work which the Secretary of Defense determines is of potential interest" and instead allows each contractor's CEO to determine that the contractor's IRAD expenses will advance DoD's needs. Section 2372 (d). Second, the 2017 NDAA unequivocally requires that, under DoD's regulations, IRAD costs "shall be considered a fair and reasonable, and allowable, indirect expense on DoD contracts." Section 2371 (b).[3]

The 2017 NDAA represents the strongest possible statement of Congress's complete confidence that the contractor – not DoD – should reach its decisions about which IRAD costs to incur. Congress intends that the contractor, not DoD, can best make those decisions, shaped by information shared by DoD but not subject to DoD's veto or constraint. The proposed IRAD rules, which by DoD's admission attempt to impose DoD's own view of the correct "balance" between long-term and near-term investment in IRAD, are clearly antithetical to Congress' intent

**IV. The proposed rule represents a misplaced double penalty on IR&D expenses**

The fundamental incentive for a company to engage in IRAD is the company's hope that its IRAD projects will lead to technological advances that will improve its competitive position in the Government and commercial marketplaces. The fundamental disincentive is higher indirect cost rates, affecting the company's competitive position.

Since its IRAD costs are applicable to the contractor's entire business, IRAD costs are an appropriate part of the company's indirect rates. By building its indirect rates into its pricing structure, the company hopes to obtain reimbursement for its IRAD costs from its customers – both commercial and Government – by making sales. But a company can only sell its products ***if its prices remain competitive***. By incurring IRAD costs and including them in its indirect cost rates, the company increases the price that it must charge in order to cover its costs; by increasing its prices, the company harms its competitive position, in both the commercial and government markets, and puts future sales at risk. By investing in IRAD,

companies gamble that their longer term technological innovation will outweigh the immediate competitive harm associated with higher overhead rates. Thus, contractors must determine their best IRAD strategy in light of these competing market forces.

Congress made it clear in the 2017 NDAA that it expects these competing market forces to stimulate ***optimal*** IRAD investment in the long term. The proposed rule seeks to add an additional, heavy-handed penalty to the mix and thereby influence the contractor's IRAD choices. Such a penalty undermines the long-term, market-based evaluation that Congress sought to promote and creates a huge disincentive to industry's pursuit of IRAD. Further, the offeror has already been "penalized" for its IRAD through higher indirect cost rates, so the proposed evaluation penalty represents a double penalty on IRAD.

In addition, a penalty on the ***first contract*** to benefit from an IRAD project is clearly misplaced. In treating IRAD as an allowable ***indirect*** cost, DoD encourages investment in research and development costs expected to benefit ***multiple cost objectives***. The cost principles encourage spreading IRAD costs over all future, benefitting contracts, thereby avoiding a situation in which the first contract to benefit from IRAD must absorb all the costs of the IRAD effort. But that is exactly what the proposed rule will do, by penalizing the first contract on which IRAD will be used

**V. The proposed rule is anti-competitive and further complicates an already-labyrinthine competitive selection process**

The procurement landscape is littered with obstacles in the form of regulations intended to promote social goals at the Government's expense. The mildest of these are the socio-economic clauses whose implementation costs are "baked into" all contractors' costs of doing business. The most extreme are evaluation penalties added to offerors' proposed costs to provide disincentives to certain disfavored behaviors. The proposed rule adds another such evaluation penalty.

Evaluation penalties can serve worthwhile social goals. For example, the evaluation penalties for large businesses competing for a contract with one or more small businesses promote those small businesses' success, make it possible for them to win contracts that otherwise would be awarded to large businesses.

But each proposal evaluation penalty has a clear cost. For such a penalty to be effective in modifying offerors' behavior, the penalty must significantly increase the chances that contract award will be made to someone ***other than*** the offeror whose actual, proposed price is lowest. In order to work, an evaluation penalty must be ***anti-competitive***.

One of the primary goals of Better Buying Power 3.0 is "ensuring that the programs we pursue are affordable." Implementation Directive. Even if the proposed evaluation penalty served an interest approved by Congress – which it demonstrably does not – the proposed IRAD evaluation penalty would be at cross purposes with DoD's expressed goal of making programs affordable. The Implementation Directive effectively acknowledges this anti-competitive result, explaining that the IRAD evaluation penalty would be applied when "promised future IRAD expenditures are used to ***substantially reduce the bid price on competitive procurements***."

**VI. Conclusions**

As a result of these concerns, we expect many of the comments submitted to DoD in response to the proposed rule will be negative. IRAD has long been a means for both the Government and contractors to gain the benefits of advanced technology and to share the costs of developing such technology across all the platforms that will benefit. If these cost sharing concepts are removed, the Government may find it much more expensive and much more difficult to continue to develop advanced technologies. As a result, we think the proposed rule should not be adopted. If it is adopted in its current form, contractors should take care to carefully monitor the costs of IRAD for purposes of proposal submissions and should be aware of the risks raised by stating that planned, future IRAD will be used to "meet the contract requirements." In addition, contractors should perform a cost-benefit analysis to determine whether pursuing additional research and development is better done as a direct charge to a specific contract rather than as a (potentially questionable) indirect charge.

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[1] Bid and proposal ("B&P") effort is similarly defined to exclude the costs of effort "required in the performance of a contract." The "required in the performance of a contract" language became part of the B&P and IRAD cost allowability provisions over 40 years ago. ASPR 15-205.35(a), 1969 *ed.*, Rev. 11, Apr. 28, 1972; 32 C.FR. § 15.205-35(a) (1974).

[2] *See Boeing Co. v. United States*, 862 E2d 290 (Fed. Cir. 1988) (only B&P costs ***specifically required*** by the terms of a contract had to be charged as direct costs of that contract); *United States v. Newport News Shipbuilding, Inc.*, 276 E Supp. 2d 539 (E.D. Va. 2003) (IRAD cost principle excluded from "independent" research and development work ***implicitly*** as well as explicitly required by a contract).

[3] The only restriction the 2017 NDAA expressly allows is that it permits DoD's regulations to "include . . . controls on the reimbursement of costs to the contractor for expenses incurred for [IRAD] to ensure that such costs were incurred for independent research and development." Section 2372 (c).




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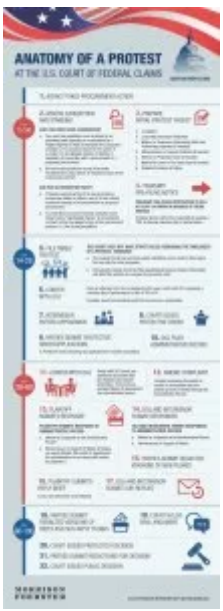


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