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Proposed Research and Development Rule Raises Numerous Issues

IR&D Costs

The authors argue there are multiple significant issues with a proposed rule revising DFARS 231.205-18, "Independent Research and Development and Bid and Proposal Costs," including apparent conflicts with the statute governing DOD payments of IR&D costs. The reason for the proposed rule is unclear and the commentary published with the proposed rule does not explain why the current regulation is not adequate.

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The Defense Acquisition Regulations System has published a proposed rule that would revise DFARS 231.205-18, "Independent Research and Development and Bid and Proposal Costs." The proposed rule would, in part, require "major contractors" to engage in a "technical interchange" with certain DOD employees before generating IR&D costs for IR&D projects initiated in the contractor's fiscal year 2017 and later. [1] The rule makes this requirement "a prerequisite for the subsequent determination of allowability." 81 Fed. Reg. 7721, 7723 (Feb. 16, 2016). Comments on the proposed rule are due by April 18.

[1] DFARS 231.205-18(a)(iii) defines "major contractor" as follows:

> Major contractor means any contractor whose covered segments allocated a total of more than $11,000,000 in IR&D/B&P costs to covered contracts during the preceding fiscal year. For purposes of calculating the dollar threshold amounts to determine whether a contractor meets the definition of "major contractor," do not include contractor segments allocating less than $1,100,000 of IR&D/B&P costs to covered contracts during the preceding fiscal year.

There are multiple significant issues with the proposed rule, including possible conflicts with the statute governing DOD payments of IR&D costs. The reason for the proposed rule is unclear. DFARS 231.205-18 already provides for substantial communications between contractors and DOD concerning IR&D costs, and the commentary published with the proposed rule does not explain why the current regulation is not adequate. Further, the proposed rule raises numerous questions concerning how it will be implemented.

In light of these issues, it is clear that DOD would benefit substantially from further analysis of the governing statute and the need for the proposed rule. If the agency still believes a proposed rule is authorized and necessary, it should change and/or clarify many aspects of the current proposed rule in another publication seeking further comments. [2]

[2] DOD also has published an Advance Notice of Proposed Rulemaking ("ANPR") indicating that DOD is considering a proposed approach requiring offerors to describe in detail the nature and value of prospective IR&D projects on which the offeror would rely to perform the resultant contract; DOD would then evaluate proposals in a manner that would take into account that reliance by adjusting the total evaluated price to the government, for evaluation purposes, to include the value of related future IR&D projects. See81 Fed. Reg. 6488 (Feb. 8, 2016). DOD held a public meeting March 3 to discuss the ANPR, and numerous attendees raised concerns with it. Both the ANPR and the proposed rule concern IR&D, and the DOD commentary in the Federal Register suggests that both arose out of DOD's "Better Buying Power" efforts. However, the ANPR raises a host of issues that are worthy of an entirely separate article.

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The Proposed Rule and Associated Commentary

DFARS 231.205-18 currently includes a section containing “Definitions” and a section concerning “Allowability.” The Allowability section contains five subsections, including subsection (iii) that provides certain rules applicable to major contractors. Subsection (iii) contains three additional subsections. The third such subsection, which is the focus of the proposed rule, currently states:

(C) For a contractor's annual IR&D costs to be allowable, the IR&D projects generating the costs must be reported to the Defense Technical Information Center (DTIC) using the DTIC's on-line input form and instructions at http://www.dtic.mil/ird/dticdb/index.html. The inputs must be updated at least annually and when the project is completed. Copies of the input and updates must be made available for review by the cognizant administrative contracting officer (ACO) and the cognizant Defense Contract Audit Agency auditor to support the allowability of the costs. Contractors that do not meet the threshold as a major contractor are encouraged to use the DTIC on-line input form to report IR&D projects to provide DoD with visibility into the technical content of the contractors' IR&D activities.

The proposed rule would divide the current language quoted above into four separate subsections, and add the following italicized language to the second sentence: “The inputs must be updated with a summary of results at least annually and when the project is completed.” 81 Fed. Reg. 7721, 7723 (Feb. 16, 2016). In addition, the proposed rule would add the following language to the end of the current version of DFARS 231.205-18(c)(iii)(C):

(5) For IR&D projects initiated in the contractor's fiscal year 2017 and later, as a prerequisite for the subsequent determination of allowability, major contractors must—

(i) Engage in a technical interchange with a technical or operational DoD Government employee before IR&D costs are generated so that contractor plans and goals for IR&D projects benefit from the awareness of and feedback by a DoD employee who is informed of related ongoing and future potential interest opportunities; and

(ii) Use the online input form for IR&D projects reported to DTIC to document the technical interchange, which includes the name of the DoD Government employee and the date the technical interchange occurred.

Id.

Inconsistent With the Governing Statute

• To the extent DOD plans to implement the proposed rule by giving designated DOD employees the authority to change or reject the technologies contractors choose to pursue in their IR&D programs, such proposed authority conflicts with the governing statute

• DOD's Regulations Concerning the Transmission of Information Between DoD and Contractors are Subject to a Significant Limitation: At the outset, the proposed rule appears to conflict with 10 U.S.C. § 2372, the statute governing DOD payments of IR&D costs. Subsection (a) of that statute states that “[t]he Secretary of Defense shall prescribe regulations governing the payment, by the Department of Defense, of expenses incurred by contractors for independent research and development and bid and proposal costs.” Subsection (c) begins: “Subject to subsection (f), the regulations prescribed pursuant to subsection (a) may include the following provisions: … .” (Emphasis added). Thus, all of the provisions in subsection (c) are subject to subsection (f), which states: “Limitations on Regulations.—Regulations prescribed pursuant to subsection (c) 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 program.”

Part of the provisions in subsection (c) that are subject to the “[l]imitations” of subsection (f) cover transmission of information between DOD and contractors:

(c) Additional Controls.—Subject to subsection (f), the regulations prescribed pursuant to subsection (a) may include the following provisions:

* * *

(3) Implementation of regular methods for transmission—

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(A) from the Department of Defense to contractors, in a reasonable manner, of timely and comprehensive information regarding planned or expected Department of Defense future needs; and

(B) from contractors to the Department of Defense, in a reasonable manner, of information regarding progress by the contractor on the contractor's independent research and development programs.

As discussed above, 231.205-18(c)(iii)(C) currently includes language requiring contractors to report IR&D projects to the Defense Technical Information Center (DTIC), and further requiring that the inputs be updated at least annually, as well as when the project is completed. And as discussed further below, DFARS 231-205-18(c)(iv) and (v) provide for communications by DOD to major contractors. The proposed rule would add to these communications by requiring a "technical interchange" with certain DOD employees.

DOD Does Not Define "Feedback": In particular, the proposed rule states that major contractors are to "[e]ngage in a technical interchange with a technical or operational DOD government employee before IR&D costs are generated so that contractor plans and goals for IR&D projects benefit from the awareness of and feedback by a DOD employee who is informed of related ongoing and future potential interest opportunities."

Yet this language does not define the term "feedback." This undefined term raises the question of whether DOD intends to implement the proposed rule by giving the appropriate DOD employee the authority to formally approve all aspects of the contractor's "plans and goals for IR&D projects" before the contractor can proceed with the projects. The undefined term "feedback" also raises the question of whether such implementation will include giving the appropriate DOD employee the authority to change or reject IR&D programs reported by a contractor, thereby redirecting the contractor's "independent" research and development activities.

As noted above, 10 U.S.C. § 2372(f) states that "[r]egulations prescribed pursuant to subsection (c) 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 program." (Emphasis added). DOD's discussion of the proposed rule in the Federal Register acknowledges 10 U.S.C. § 2372(f), but makes certain assertions purportedly in support of the proposed rule:

In accordance with 10 U.S.C. 2372(f), contractor IR&D investments are not directed by the Government—they are identified by individual companies and are intended to advance a particular company's ability to develop and deliver superior and more competitive products to the warfighter. However, these efforts can have the best payoff, both for DoD and for individual performing companies, when the Government is well informed of the investments that companies are making, and when companies are well informed about related investments being made elsewhere in the Government's research and development portfolios and about Government plans for potential future acquisitions where this IR&D may be relevant.

This language does not address whether DOD intends to implement the proposed rule by giving authority to the appropriate DOD employees to change or reject the technologies contractors choose to pursue in their IR&D programs.

• DOD's April 2015 BBP Memorandum: An important DOD memorandum – cited in the commentary accompanying the proposed rule – strongly suggests that DOD intends to implement the proposed rule in a manner that would infringe on a contractor's independence to choose which technologies to pursue in its IR&D program.

• The commentary accompanying the proposed rule refers to DOD's "Better Buying Power" efforts, citing in particular "the Under Secretary of Defense for Acquisition, Technology, and Logistics BBP 3.0 Implementation Memorandum, dated April 9, 2015." 81 Fed. Reg. 7721-22 (Feb. 16, 2016) (April 2015 BBP Memorandum). [3] The April 2015 BBP Memorandum, under the heading "Increase the productivity of corporate Independent Research and Development," provides "General Guidance," including:

[3] The commentary indicates that, as stated in the referenced memorandum, "IR&D investments need to meet the complementary goals of providing defense companies an opportunity to exercise independent judgment 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. To achieve this goal, both DoD and the industrial base need to work together to ensure that DoD has visibility into the opportunity creased by Government-reimbursed IR&D efforts performed by defense contractors." Id. at 7722.

Independent Research and Development (IRAD) conducted by defense companies as an allowable overhead expense is an important source of innovation for both defense corporations and DoD. It represents over $4 billion in annual Research and Development (R&D) spending. Changes in legislative guidance and authorities in the early 1990s removed almost all DoD supervision of corporate IRAD. Until that time, IRAD had been tightly regulated and heavily supervised by DoD. This initiative will improve communication between DoD and industry and restore a higher degree of government oversight of this

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technology investment, while avoiding the burdensome regulatory environment that existed prior to the early 1990s.

April 2015 BBP Memorandum at 11 (emphasis added.) This language acknowledges that legislation "removed almost all DoD supervision of corporate IRAD," yet goes on to state that "[t]his initiative will improve communication between DoD and industry and restore a higher degree of government oversight of this technology investment." (Emphasis added). This language strongly suggests that DOD intends to "restore" (at least in part) "government oversight" that congressional "legislat[ion]" removed. Of course, DOD does not have authority to change legislation.

The April 2015 BBP memorandum contains additional language clearly suggesting that DOD intends to infringe on a contractor's right to choose which technologies to pursue:

The intent of the actions below is to ensure that IRAD meets the complementary goals of providing defense companies an opportunity to exercise independent judgment 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.

Id. at 12 (emphasis added). The first sentence refers to "The intent of the actions below." Those actions include the following: "The new guidelines will include: identification and endorsement of an appropriate technical DD sponsor from the DoD acquisition and technology community prior to project initiation … ." Id. (emphasis added). This indicates that DOD may plan to implement the proposed rule by giving the DOD employee involved in the "technical interchange" the authority to "endorse" proposed IR&D projects before costs are generated.

In addition, to the extent the "laissez-faire approach of the last few decades" resulted from and is consistent with the governing statute, 10 U.S.C. § 2372, that approach is what the statute intended. And to the extent that DOD's goal of "restor[ing] the balance" involving "technologies" means that DOD intends to implement the proposed rule by infringing on a contractor's right to choose which technologies to pursue, this goal conflicts with the statute.

DOD's March 3, 2016, Public Meeting: On March 3, DOD held a public meeting to discuss the ANPR mentioned in footnote 2 above. Based on personal notes of that meeting, a DOD representative noted that a Better Buying Power 3.0 memorandum indicates that IR&D projects are pursued often based on near-term solutions.

That representative seemed to indicate that the DOD ANPR approach arose from a fairness perspective, and to encourage companies to focus on the next generation of solutions. Also at the meeting, a DOD representative stated that DOD is looking for ways to incentivize the portfolio mix. An attendee asked if, by incentivizing the portfolio mix, DOD means long-term versus short-term investments. A DOD representative said: No, we want you to have a mix, because the view now is there is not much of a mix. DOD wants clarity on the mix and thoughts about how to incentivize it. [4]

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[4] Similarly, the April 2015 BBP memorandum states: "Reviews of IRAD spending indicate 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." April 2015 BBP memorandum at 11.

DOD Statements Raise the Question of How DOD Plans to Implement the Proposed Rule: The proposed rule does not specifically grant DOD the authority to change, reject or otherwise infringe on the independence of a contractor to choose which technologies to pursue in its IR&D program. However, statements in the April 2015 BBP memorandum and at DOD's March 3 public meeting strongly suggest that DOD may implement the proposed rule in a manner that causes such infringement.

The proposed rule therefore raises the question of whether DOD plans to implement the proposed rule by taking the position that the "feedback by [the] DoD employee" includes the authority to direct changes to, reject or otherwise infringe on the independence of a contractor to choose which technologies to pursue in its IR&D program.

If that is the case, the proposed implementation is at odds with the IR&D statute, which specifies that regulations concerning the transmission of information between DOD and contractors, promulgated pursuant to 10 U.S.C. § 2372(c)(3), are subject to the limitation in 10 U.S.C. § 2372(f) that "[r]egulations prescribed pursuant to subsection (c) 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 program." (Emphasis added).

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In other words, 10 U.S.C. § 2372(c)(3)(A) permits regulations concerning the transmission of information from DOD to contractors "of timely and comprehensive information regarding planned or expected Department of Defense future needs," but 10 U.S.C. § 2372(f) expressly precludes any such regulations from infringing on the independence of contractors to choose which technologies to pursue in their IR&D programs.

Conflict with 10 U.S.C. §2372(c)(3)(B)

The proposed rule is also inconsistent with the governing statute because the proposed rule requires major contractors to engage in a "technical interchange" with certain DOD employees "before IR&D costs are generated." However, as noted previously, 10 U.S.C. § 2372(c)(3)(B) authorizes regulations concerning the implementation of regular methods for transmission "from contractors to the Department of Defense … of information regarding progress by the contractor on the contractor's independent research and development programs." (Emphasis added).

The only information required by statute to be transmitted by contractors is the "progress" by the contractor on IR&D programs. Thus, the statute does not require contractors to transmit information about proposed future IR&D programs, but only requires the transmission of information about such programs after they have begun and the contractor has already incurred associated costs. Accordingly, this statutory language conflicts with the proposed rule's requirement that the contractor "[e]ngage in a technical interchange with a technical or operational DoD Government employee before IR&D costs are generated." (Emphasis added).

Inconsistent With DFARS 231.205-18 Prohibition

DFARS 231.205-18(c)(i) states: "Departments/agencies shall not supplement this regulation in any way that limits IR&D/B&P cost allowability." The proposed rule specifically states that the proposed requirements are "a prerequisite for the subsequent determination of allowability." Thus, by adding new "prerequisite[s]" for the allowability of IR&D costs – prerequisites that "limit IR&D … cost allowability" by requiring a technical interchange prior to incurring IR&D costs – the proposed rule appears inconsistent with DFARS 231.205-18(c)(i).

Inappropriate Applications of Statutes and Regulations

The April 2015 BBP memorandum states: "In BBP 3.0, we will continue to work with industry to identify unproductive or non-value added regulatory activities. Examples include updating statutes, regulations, and policies and removing inappropriate or inconsistent DoD practices and applications of statutes and regulations." April 2015 BBP Memorandum at 21 (emphasis added). As such, the memorandum recognizes that DOD should not engage in "inappropriate" "applications of statutes and regulations." This underscores the need for DoD to take a hard look at the proposed rule in the context of the governing statute and the referenced prohibition in DFARS 231.205-18.

Current DFARS 231.205-18 Already Provides for Substantial Communications

The proposed rule, as well as DOD's commentary accompanying that rule, do not acknowledge that current DFARS 231.205-18 already provides for substantial communications between major contractors and DOD. As such, DOD has not offered an explanation of why the current requirements providing for such communications are not adequate, or do not (as stated in DOD's discussion of the proposed rule) "ensure that both IR&D performers and their potential DoD customers have sufficient awareness of each other's efforts and … provide industry with some feedback on the relevance of proposed and completed IR&D work." 81 Fed. Reg. 7721, 7722 (Feb. 16, 2016).

As discussed above, the current DFARS 231.205-18(c)(iii)(C) requires major contractors to report information to DTIC concerning IR&D projects for the contractors' annual IR&D costs to be allowable. That DFARS provision also requires major contractors to update these inputs at least annually and when the project is completed. In addition, "[c]opies of the input and updates must be made available for review by the cognizant [ACO] and the cognizant [DCAA] auditor to support the allowability of the costs."

Also, DFARS 231.205-18(c)(iv) provides for communications by DOD to major contractors as follows:

(iv) For major contractors, the ACO or corporate ACO shall—

(A) Determine whether IR&D/B&P projects are of potential interest to DoD; and

(B) Provide the results of the determination to the contractor.

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In addition, current DFARS 231.205-18(c)(v) provides for even more communications by DOD to major contractors:

(v) The cognizant contract administration office shall furnish contractors with guidance on financial information needed to support IR&D/B&P costs and on technical information needed from major contractors to support the potential interest to DoD determination (also see 242.771-3).

DOD's commentary accompanying the proposed rule does not explain that there are any problems with the communications required by DFARS 231.205-18(c)(iii)(C), (c)(iv), and (c)(v), or why there should be additional regulations governing communications between major contractors and DOD.

A recent article by the Under Secretary of Defense for Acquisition, Technology, and Logistics – the author of the April 2015 BBP memorandum – deals with "Better Buying Power Principles[,] What Are They?" Defense AT&L: January-February 2016 at 2. That article states "Data should drive policy." Id. at 3. If DOD believes the current DFARS provisions requiring significant communications between major contractors and DOD are not working, DOD should put forward data supporting this position.

Numerous Implementation Questions

The proposed rule adds significant requirements to DFARS 231.205-18. Yet the proposed new requirements are basically set forth in a single sentence, beginning at new subsection 231.205-18(c)(iii)(C)(5), with no accompanying definitions. This single sentence raises numerous questions concerning how the proposed rule would be implemented.

One of these questions, discussed above, is what DOD means by having the appropriate DOD employee provide "feedback" to major contractors. This question, in turn, raises other questions. If DOD intends to implement the proposed rule by giving the appropriate DOD employee authority to change or reject IR&D programs reported by a contractor, that raises the question of what happens if the contractor reasonably changes material aspects of the "contractor plans and goals for IR&D projects" (e.g., because of technological advances) reported as part of the technical interchange after the contractor has received the "feedback" from the appropriate DOD employee. In that situation, are costs incurred in connection with the changed approach still allowable? Similarly, what if the contractor reasonably decides to shut down an IR&D project after the contractor has received the "feedback" from the appropriate DOD employee – are the IR&D costs incurred after receiving DOD's feedback and prior to ending the project allowable? Is the contractor permitted to end the project at this point?

Will DOD Discuss Other Projects With the Contractor Engaged in the Technical Interchange?

The proposed rule requires the a technical interchange "so that contractor plans and goals for IR&D projects benefit from the awareness of and feedback by a DoD employee who is informed of related ongoing and future potential interest opportunities." 81 Fed. Reg. 7721, 7723 (Feb. 16, 2016) (emphasis added). Also, DOD's discussion of the proposed rule includes: "However, these efforts can have the best payoff, … when companies are well informed about related investments being made elsewhere in the Government's research and development portfolios and about Government plans for potential future acquisitions where this IR&D may be relevant." Id. at 7722 (emphasis added). These statements at least imply that the government will be discussing other contractors' IR&D projects with the contractor engaging in the technical interchange.

If that is the case, it raises the question of how much detail contractors should provide as part of the technical interchange about projects the contractor considers to be confidential and competitively sensitive. If DOD implements the proposed rule by requiring contractors to provide proprietary information, and assuming such implementation is valid, contractors understandably will want to know what specific protection(s) will be in place to ensure that trade secrets and proprietary information (e.g., a new invention) of Contractor A are not disclosed to Contractor B.

In the absence of adequate protections, contractors may think long and hard about pursuing IR&D projects – which can benefit commercial work – if there are material risks that confidential information about those projects disclosed to DOD could in turn be disclosed to competitors. A disincentive to avoid engaging in IR&D projects would run counter to 10 U.S.C. §2372(g), which states in part: "The regulations under subsection (a) shall encourage contractors to engage in research and development activities of potential interest to the Department of Defense … ."

Other Questions

The proposed rule raises a host of other questions concerning how it will be implemented. For example, the proposed rule does not indicate how contractors are supposed to "[e]ngage in" the "technical interchange." Should they meet with the appropriate DOD employee, or is a "technical interchange" by telephone or e-mail sufficient?

Nor does the proposed rule define "technical interchange," or indicate what information contractors are required to report that

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they currently are not required to report to DTIC, other than using the general term “contractor plans and goals for IR&D projects.” The term “plans and goals” is not defined. Similarly, the proposed rule does not indicate how much information is required to be reported.

The proposed rule raises the question of whether DOD plans to implement the proposed rule by giving the appropriate DOD employee the discretionary authority to take the position that the contractor allegedly has not provided sufficient information, and require the contractor to provide more information until the DOD employee is satisfied with the information submitted.

As another example, the proposed rule does not indicate who at DOD qualifies as an appropriate a “technical or operational DoD Government employee” and “DoD employee who is informed of related ongoing and future potential interest opportunities” to whom the contractor must report information. Similarly, the proposed rule raises the question of what, if any, relationship will exist between the DOD employee and the ACO with respect to determining allowability of IR&D costs.

In addition, the proposed rule does not indicate when the appropriate DOD employee is required to provide the “feedback” referenced in the proposed rule. What happens if the DOD employee materially delays providing such feedback, which prevents the contractor from incurring IR&D costs (the proposed rule states that the technical interchange must occur “before IR&D costs are generated”)?

Moreover, the proposed rule states that major contractors are to “[u]se the online input form for IR&D projects reported to DTIC to document the technical interchange, which includes the name of the DoD Government employee and the date the technical interchange occurred.” 81 Fed. Reg. 7721, 7723 (Feb. 16, 2016).

This statement raises the question of how much information contractors should include in the form about the technical interchange. In addition, will DOD implement the proposed rule by giving the DOD employee involved in the technical interchange authority to edit the contractor's description of the interchange? Further, will DOD give the DOD employee (or the ACO, or anyone else in the government) the authority to tell the contractor that the contractor's description of the interchange is inadequate and needs to be revised?

Finally, the proposed rule raises the question of whether DOD plans to have DCAA audit any aspect of the technical interchange contemplated by the proposed rule, and make recommendations to the ACO. Note that current DFARS 231.205-18(c)(iii)(C) requires that copies of input and updates concerning IR&D projects “must be made available for review by the cognizant administrative contracting officer (ACO) and the cognizant Defense Contract Audit Agency auditor to support the allowability of the costs.”

If DOD intends to implement the proposed rule by having DCAA audit the technical interchange and make recommendations to the ACO, that raises the question of whether DOD contemplates DCAA having authority to request records supporting the IR&D project(s). These questions are not addressed in the proposed rule or the accompanying commentary.

Conclusion

The proposed rule presents a host of questions that DOD should address. Most striking, DOD statements in the April 2015 BBP memorandum and at the March 3 public meeting suggest that DOD is seeking to implement the proposed rule by giving the appropriate DOD employee the authority to change or reject the particular technologies contractors plan to pursue as part of their IR&D programs.

To the extent DOD seeks to do that through new regulations, it must keep in mind the fundamental restriction of 10 U.S.C. § 2372(f): “Regulations prescribed pursuant to subsection (c) 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 program.”

Given the number and significance of questions raised by the proposed rule, DOD would benefit from conducting further analysis. If DOD concludes that some sort of amendment to DFARS 231.205-18 is still authorized by law and necessary, it should issue another proposed rule for further comments.

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