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Knowing Your Cost Principles and Cost Accounting Standards…

COMPENSATION FOR PERSONAL SERVICES

(Editor's Note. About eleven years ago we wrote a three-part series on compensation for personal services based on an article written by Karen Manos. Since then Karen, now with Gibson, Dunn & Crutcher LLP, wrote another article in the December 2007 issue of Briefing Papers. We found the newer article updated many of the compensation areas previously covered to reflect both FAR changes and board decisions so we used her updated views to modify our earlier article. This time we will not address the history of the salary caps applicable to executives of large companies nor the bases of government reviews and challenges of executive salaries of smaller companies since we have addressed these two issues several times in the past and plan to recount a case study challenging government assertions of unreasonable executive salaries soon.)

Employee compensation is the single largest element of cost by many contractors. The government is, not surprisingly, quite interested where a significant subset of compensation, executive compensation, has become the number one area of audit scrutiny. The FAR cost principle 31.205-6, "compensation for personnel services" is the longest and most detailed of the FAR cost principles and holds the record for most revisions (over 32) in the last 15 years.

The cost principle defines "compensation" broadly:

"Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred for services rendered by employees to the contractor during the period of contract performance. Compensation includes payments made or to be made in the future in the form of cash, corporate securities (e.g. stock, bonds) and other assets, products or services."

Criteria for Allowability

Five general criteria, FAR 205-6(a)(1) through (5), must be met for costs of personal compensation to be allowable.

1. With limited exceptions such as severance pay, deferred compensation, pension and other post retirement benefits compensation must be for work performed in the current year and may not be for retroactive payment for work performed in prior years.

2. Compensation in total must be "reasonable" for the work performed. The cost principle has undergone considerable changes in clarifying what is "reasonable" which is defined in paragraph (b) which we will discuss below.

3. Compensation must be paid in accordance with "an established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make payment". Does this mean it needs to be in writing? Boards of Appeals have ruled that a compensation policy can be held to exist without being in writing even when costs were incurred for the "first time" (*Boeing, ASBCA 46274*). On the other hand, a Board disallowed bonus payments when a survey of employees indicated the majority of employees said they did not believe a promise or agreement existed (*Petroleum Operations & Support Services, EBCA 291-6*). It certainly is easier to prove an established policy or practice if the compensation program is set forth in writing and communicated to employees.

4. There is no presumption of allowability where the contractor has failed to notify the contracting officer of a "major revision" to its compensation plan or practices. Conversely, the author states there will be such a presumption if the contractor notifies the ACO and gives them the opportunity to review the change.

5. Costs unallowable under other cost principles are not considered allowable simply because they are called "compensation". For example, costs of membership in social, dining or country clubs made unallowable under "Entertainment Costs" are still unallowable even if reported as income to employees.

In addition to these general criteria, the cost principle states that special consideration is required for (1) owners of closely held corporations, members of limited liability companies, partners, sole proprietors or members of immediate family and (2) persons who are contractually committed to receiving a substantial interest in the company. For these people,

compensation must not only be "reasonable" but must not constitute a distribution of profits and for owners of closely held corporations, the compensation must be tax deductible.

♦ What is Reasonable

For compensation costs to be considered reasonable, (1) compensation "in total" must be reasonable and (2) each of the allowable elements of the compensation package must also be reasonable.

FAR 31.201-3 provides a list of factors for a cost to be considered "reasonable." In sum they include the prudent person rule i.e. what such a person would do under normal circumstances. Reasonableness is to be determined on a case-by-case basis and factors to be considered include: (1) whether the cost is recognized to be "ordinary and necessary" " for conduct of its business (2) results from sound business practices conducted at arm-length and (3) do not significantly deviate from contractors' established practices.

In addition to the above general factors COs are instructed to consider "other relevant factors" such as (1) general conformity with the compensation practices of other firms of the same size (2) firms in the same industry (3) firms in the same geographic area (4) firms engaged in predominately non-government work and (5) cost of comparable services that are obtainable from outside sources. Though the regulations give the contractor the discretion to determine which of the above factors are relevant, FAR 31.205-6(b)(1) states the "appropriate factors are representative of the labor market for the job being evaluated". So, for example, if the firms competing for a contractor's top executives are larger, national corporations in the same industry, the compensation practices of those firms might be more relevant than comparable practices of companies of the same size or in the same geographic areas.

The author addresses the evolution of these factors. An interesting change was that the burden of proof has changed where it is now put on the contractor when the government challenges total compensation or any element within it. Such a burden is important where, for example, in an earlier case before the change, the courts held that compensation that was 30% higher than average was upheld because the government had not "effectively rebutted" the contractor's argument its salary was within the range of reasonableness (*Lulejian & Associates, ASBCA 20094*).

♦ Offsets

Though total compensation and each element of the comp package must be reasonable, offsets between allowable elements are permitted. There have been numerous modifications to the offset provisions through the years but currently section (b)(1) provides that the government will consider not only circumstances surrounding the compensation item being challenged but also the magnitude of other compensation elements which may be lower than would be considered reasonable. The cost principle imposes certain limitations:

1. Offsets will be allowed only between the following compensation elements: (a) wages and salaries (b) incentive bonuses (c) deferred compensation (d) pension and savings plan benefits (e) health insurance benefits (f) life insurance benefits and (g) compensated personal absence benefits.

2. Elements whose amounts are not measurable cannot be used as offset items.

Specific Elements

♦ Income Tax Differential Pay

The cost principle expressly permits the cost of differential allowances for additional income taxes resulting from *foreign* assignments (e)(1). Costs of tax "gross-ups" to compensate employees for additional federal, state or local income taxes resulting from a *domestic* assignment are not allowable (e)(2). However, gross-up payments for income and FICA taxes are allowable for relocation costs (FAR 31.205-35(a)(10).

♦ Bonuses and Incentive Compensation

Use of bonuses has proliferated in recent years, especially where bonuses and incentive pay are based on corporate performance. Some considerations include if the bonus or incentive pay is deferred, the costs must satisfy the allowability criteria for deferred compensation (discussed below) or if they relate to business acquisitions and mergers special rules apply (also discussed below). Auditors will commonly look for ways to challenge the basis for payment. For example, bonuses paid on the basis of total sales might be questioned because they would result in an improper cost-plus-percentage-of-cost contract. Or, auditors may assert that bonus or incentive compensation was not paid pursuant to an agreement entered into before the services were performed. To counter this assertion it should be noted that

employees need not have had the *right* to receive the bonus provided there was a reasonable *expectation* the bonus would be paid (*Boeing Aerospace, ASBCA 46274*). Also, Appeals boards have held that some management discretion in making payments is permissible (*Boeing Co., ASBCA 24089*).

♦ Severance Pay

Severance pay is considered payment in addition to salary and wages to workers whose employment is being involuntarily terminated. The costs must be reasonable and either required by law, employee-employer agreement, established policy that effectively constitutes an implied agreement or part of the circumstances for employment. The payment is unallowable if the employee is employed by a replacement contractor or employed by an affiliate of the contractor. "Normal" severance pay must be allocated to all work performed in the contractor's plant. Though accruals for "abnormal" or "mass" severance is not permitted, the Government is obligated to pay "its fair share" of the payment. *ITT Federal Services Corp (ASBCA 46146*) held that the contractor is not entitled to recover severance costs under fixed-price contracts if not included in its proposed overhead rate.

Though earlier regulations prevented both severance and early retirement pay, later changes to the cost principle allows the cost of both as long as the present value of the early retirement pay package does not exceed the employee's annual salary for the fiscal year before their retirement (J)(6)(iv).

There have also been changes to employee release agreements where employees are given more severance pay than they would otherwise receive in exchange for releasing the contractor from potential liability for wrongful termination. DCAA initially took the position such costs were unallowable because they represented payment for work not performed. DOD firmly rejected DCAA's position, forcing DCAA to issue guidance prohibiting auditors from questioning such payments because they are unallowable backpay for work not performed and directed auditors to examine such payments on a case-by-case basis for reasonableness.

Special rules were adopted for severance pay to foreign nationals employed under service contracts performed outside of the US. Such costs cannot exceed amounts typically paid to employees providing similar services within the US and they are not allowable if the foreign national's employment was terminated as a result of a closing or curtailment of activities at a US facility at the request of that country's government. This limitation used to apply to only DOD but recent services contracts let by other agencies have made the limitation apply government-wide.

♦ Backpay

The most substantive changes made in 2003 were changes affecting section (h) of the cost principle, backpay. Before the changes cost of backpay was unallowable only when it resulted from a violation of federal labor laws or the Civil Rights Act. The 2003 revision made *all* backpay unallowable unless it was for work performed but underpaid. Commentors to the proposed changes stated several types of reasonable backpay compensation would be unallowable under the changes e.g. retroactive adjustments to salary and wages, payments made before there was any ruling about federal labor or civil rights violations, settlements made to wrongful discharge cases to reduce litigation costs. In spite of what the author states was a significant change, the government simply asserted the 2003 changes were nothing more than "clarifications" of earlier rules.

♦ Corporate Securities

Compensation, especially for executives, frequently includes payments in the form of contractor's corporate securities such as stock options and stock appreciation rights. The government has imposed additional restrictions on allowability of this form of compensation:

1. Securities must be valued at their fair market value on the "measurement date" (the first date the number of shares awarded is known).

2. Accruals for the cost of the securities before issuance to employees must take into account the possibility some employees' interests in the accrual will be forfeited.

3. Compensation calculated or valued on the basis of changes in the price of the securities (e.g. stock appreciation rights, phantom stock plans and junior stock conversions) are unallowable. This is true even if the payments otherwise meet the criteria for incentive compensation. Prior to 1996, the cost principle was frequently revised to account for new creations of stock-based compensation e.g. stock appreciation rights, phantom stock plans, etc. In 1996 the cost principle was revised to provide a "general allowability rule" for stock-based compensation not tied to any particular type.

4. For stock options, allowable costs are limited to the difference between the option price, if lower and the market price of the stock on the first date both number of shares and option price are known. Since option prices are generally equal or greater than the market price, stock options are generally unallowable.

5. Compensation in the form of dividend payments are unallowable because they are considered "distribution of profits".

♦ Pension and Other Post Retirement Benefits

Pension Plans. Paragraph (j) contains rules governing allowability of pension costs. There are two types of pension plans: (a) defined benefit, where benefits are determined in advance and the contractor makes contributions deemed necessary to provide the benefits and (b) defined contribution, where contributions are defined in advance and benefits vary depending on the plan's actuarial and investment experience. The "funded pension cost" is the portion paid to a funding agency established to accumulate the contributions and subject to limitations in (j)(1) through (6) the costs of the pension plans are allowable provided they are measured, allocated and accounted for in accordance with CAS 412 and 413. Pension payments must be reasonable, paid pursuant to a good faith agreement entered into before the work or services were performed and consistent with an established pension plan. Cost of living adjustments are allowable if part of a policy or practice. Pension costs must be funded by the time set for filing the contractor's federal income tax (including any extension for filing). If not funded and absent a waiver under the Employee Retirement Income Security Act of 1974, any pension costs assignable to the current year are unallowable and may not be charged to any future year. Moreover, increased costs caused by delays in quarterly contributions are also unallowable. On the other hand, premature funding of pension plans must be charged to the period they would be assignable. The costs of changes in a pension plan that are discriminatory to the government or not intended to be applied consistently for all similarly situated employees are unallowable. With the exception of early retirement benefits, one-time only supplemental benefits not available to all participants of the basic plan are unallowable unless they represent a separate pension plan and the benefits are payable for life at the option of the employee.

Early Retirement Benefits. These costs must be accounted for and allocated in the same manner as pension costs – payments must be made in accordance with the contractor's early retirement incentive plan and applied only to active employees. In addition, the total allowable amount of such incentive payments may not exceed those employees' annual salary for the fiscal year prior to retirement.

Post Retirement Benefits. Like other costs, PRB must be reasonable and incurred pursuant to law, employee-employer agreement or an established plan. PRB costs must be accounted for on a cash, terminal funding or accrual basis. Like pension costs, they must be funded by the federal income tax return filing date and increased costs caused by delays to quarterly payments are unallowable. The allowability of PRB attributable to past service is limited to the amount that would be assigned under the "delayed recognition" provisions of Financial Accounting Standards Statement 106 no matter what method was used by the contractor for financial accounting purposes. Most notably, though FAS 106 requires use of the accrual basis for financial purposes, a government contractor may select the cash basis (recognized when benefits are paid) or terminal funding (lump sum liability paid is amortized over 15 years) for government costing purposes.

♦ Employee Stock Ownership Plans

The compensation cost principle defines an employee stock ownership plan (ESOP) as "a stock bonus plan designed to invest primarily in the stock of the employer corporation." ESOPs are generally administered by an employee stock ownership trust (ESOT) to which the employer makes annual contributions in the form of stock, cash or property. ESOP benefits must be paid or is payable at the option of the employee for life. ESOPs are classified as leveraged or non-leveraged. Under a leveraged ESOP, the ESOT borrows money to purchase the stock of the contractor where the stock is held by the lender as collateral until the loan is paid. Thereafter, the contractor makes contributions to the ESOT in an amount equal to the principal and interest on the ESOT's loan and the ESOT uses the contribution to pay off the loan (one of the few times "interest" costs are allowable). As the loan is repaid, the lender releases the stock which is then distributed to the ESOT to participating employees where they, in turn, typically receive the stock or cash equivalent upon retirement or termination from the plan.

Though the article addresses a lengthy history of regulations affecting ESOP costs, the final rule changes in 2004 are the most comprehensive. The changes (1)

moved ESOP coverage to a new paragraph (q) in the cost principle (2) if an ESOP meets the definition of a pension plan its costs must be measured, assigned and allocated in accordance with CAS 412, pension costs while if it does not meet the definition of a pension plan, the ESOP costs must be so measured in accordance with CAS 415, deferred compensation (3) ESOPs must be funded by the time set for filing federal income tax returns, including extensions (4) ESOP contributions exceeding tax deductibility limits are unallowable (5) if contributions are in the form of stock, the cost is limited to the fair market value of the stock on the date title is transferred to the trust (if FMV is not easily determinable – say, closely held corporations then the valuation is made on a case-by-case basis using IRS valuation guidelines) and (6) when contributions are in the form of cash, stock purchases by the ESOT in excess of fair market value are unallowable. If stock purchases are in excess of fair market value the contractor must credit the amount of excess to the same indirect cost pool that were charged for the ESOP contributions in the year of the stock purchase.

♦ Deferred Compensation

Deferred compensation refers to compensation in a future cost accounting period for services in one or more prior periods. It does not include year-end accruals for salary, wages or bonuses paid within a reasonable period of time. To be allowable, deferred compensation must be based on current or future services and be measured and accounted for in conformity with Cost Accounting Standard 415 (whether or not the contractor is CAS covered). CAS 415 requires costs be (1) measured by the present value of future benefits to be paid using the discount rate established by the Secretary of Treasury at the time the cost is assigned and (2) assigned to the cost accounting period the contractor incurs the obligation. Six other conditions must be met for deferred compensation to be allowable in the current period:

a. The requirement to make future payments cannot be unilaterally avoided by the contractor
b. The compensation award must be satisfied by future payment of cash, stock or other assets
c. The amount of future payment must be determinable with reasonable accuracy
d. The recipient of the award must be known
e. If receipt of the award is based on occurrence of future events, there must be a reasonable probability that such events will occur
f. For stock options, there must be a reasonable probability the options will ultimately be exercised.

If any of these conditions are not met, then the cost must be assigned to the cost accounting period the payment is actually made.

♦ Payments Related to Mergers and Acquisitions

Two types of employee payments related to M&As are unallowable. First, “golden parachutes” where payments are made to employees under agreement where they receive special compensation in excess of normal severance pay if their employment is terminated as a result of a change in management control or ownership. Second, “golden handcuffs” are unallowable as part of payment made to keep employees when management control or ownership changes.

In addition, DOD Appropriations Acts since 1996 have prohibited bonus costs in excess of normal salary when such payments are part of the restructuring costs associated with a business combination. This limitation does not apply, however, to severance payments or early retirement payments.

♦ Fringe Benefits

Fringe benefits are defined as allowances in addition to regular wages and salaries. Fringe benefits commonly include free parking, use of company-owned cars, life and disability insurance and ownership in social, dining or country clubs as well as normal fringe benefits provided to all employees (e.g. health insurance, vacation/sick/holiday leave, etc.). To be allowable, the costs must be reasonable and required by law, employer-employee agreement or established policy.

Fringe benefits, whether or not included as taxable income to the employee, are also considered in determining the overall compensation paid to the employee which must be reasonable. The statutory “cap” imposed by the Department of Defense in earlier years included fringe benefits but that has been eliminated where now the cap does not include fringe benefits.

Certain fringe benefits are unallowable. These include (1) employee rebates and purchase discounts (2) personal use of company-furnished automobiles, including home-to-work transportation and (3) costs of memberships in social, dining and country clubs.

FALLACIES OF COMMERCIAL ITEMS

(*Editor's Note. Since passage of the Federal Acquisition Streamlining Act (FASA) of 1994 the government has been emphasizing procuring "commercial items" rather than government-unique supplies and services. Offering the government "commercial items" usually benefits contractors – onerous FAR terms and conditions are eliminated, offering of prices that are not based on costs eliminates the need to demonstrate compliance with strict accounting rules and pricing of such items can be much more flexible. Though there has been a recent increase in rules justifying submission of cost data to demonstrate reasonableness of offered prices, even on commercial items, claiming commercial status of offered items still has enormous advantages. We came across an interesting article in the May 2008 issue of Contract Management written by Doris Holingsworth Gray, who is a contracts manager at Avnet Inc, that helps clarify some of the issues commonly encountered in this still murky area of commercial item acquisitions. We have changed points of emphasis but the following substantially reflects Ms. Gray's ideas. A more in-depth discussion of what is a commercial item has been addressed in a prior articles (use our Word Search at govcontractassoc.com) and probably will be reflected in future ones but the several fallacies we discuss below does address common misunderstandings we often encounter.*)

FAR Part 12, Acquisition of Commercial Items was developed to address acquisition of commercial items and the government and contractors have creatively used the new regulations to acquire commercial supplies and services to meet its needs. Nonetheless there is still widespread misconceptions of commercial items where the following seven common fallacies are among the top.

1. *A product must be developed at private expense to be a commercial item.* With the exception of non-developmental items (i.e. previously developed items of supply used exclusively for federal, state, local or foreign government purposes), an item does not have to be developed at private expense to be commercial. A commercial market may develop after a product was developed at government expense or conversely, an item developed at private expense may not have a commercial application. The issue of who paid for the item does not determine whether or not the item is commercial.

2. *How price is developed will determine whether the items are commercial.* The amount of the price or how it was determined has nothing to do with the commerciality of an item. The commerciality of the item is determined before and is separate from how the price was developed and whether or not that price is "reasonable.

3. *When modification to an item meets the definition of a commercial item price reasonableness of that modification can be substantiated only if cost or pricing data is provided.* Though requests for cost or pricing data is still common, at both the government and prime contract level, procurement personnel are instructed to first obtain multiple quotes from supplies who can perform. If competition is inadequate, then either price analysis – defined as evaluating price without evaluating separate cost elements – or market research should be conducted.

4. *FAR clauses should be flowed down to all subcontractors.* FAR 52.212-5, Contract Terms and Conditions, Commercial Items is included in prime contracts which includes terms that are supposed to, to the maximum extent practical, reflect customary commercial practice. However, prime contractors should not automatically flow down these terms to their lower tier subcontractors. The clause was intended to be for the prime contractor and some or all of these terms may be needed to be flowed down depending on the end product and prime contractor's responsibilities. However, in many instances, FAR 52.244-6, Subcontracts for Commercial Items should be enough.

5. *A product being procured to meet unique government requirements or contractor specs is a government-unique item that is a noncommercial item.* This is a common fallacy held by otherwise savvy procurement officials in both government and industry. Just because an item is being procured to meet government requirements does not automatically make it a government-unique item if it is closely related to items available commercially. The words "of a type" in the commercial item definition was intended to give the government flexibility to purchase custom items from commercial sources. To maintain its commerciality, the government-unique items must be sufficiently like other items it sells or offers for sell to the general public.

6. *If a contractor is supplying a noncommercial item (or military end item) then the contractor has to flow down noncommercial terms to its subcontractors.* It is very common to find procurement personnel who believe subcontracts must mirror the prime no matter whether the acquisition is for a commercial item. FAR 44.402(a)(2)(i) and (ii) provides that all prime and

higher tier subcontractors shall not be required, to the maximum extent possible, to apply to its subcontractors or company affiliates furnishing commercial items any clause except those (a) required to implement provisions of law or executive orders or (b) considered to be customary commercial practices for the item being acquired. FAR 52.244-6 discussed above permits the flow down of a "minimal number of additional clauses necessary to satisfy contractual obligations." This clause should prevent the opening of unnecessary "floodgates" of clauses that may be in the prime contract.

7. *Commercial items should be tested and inspected prior to acceptance*. Commercial supplies are commonly requested to conduct the same QA systems applicable to noncommercial items where the additional costs for pre-acceptance testing is not even recovered by the commercial supplier. In spite of specific quality assurance requirements prior to acceptance, contracts for commercial items should rely on a contractor or subcontractor's existing QA systems in lieu of those applying to the prime unless it is customary market practices to include in-process inspections.

Classic Oldie...

COST AND PRICING CONSIDERATION IN FORMING JOINT VENTURES AND SEPARATE UNITS

(*Editor's Note. For a lot of good reasons, we have seen significant growth in companies forming teaming arrangements and creating new business units within existing firms to pursue government contracting opportunities. We addressed some of the issues in forming these arrangements and selling them to the government in a recent article (DIGEST Q307) where we have received several questions relating to cost issues of these arrangements (not surprising since that is our specialty) so we decided to present an updated version of a piece we wrote several years ago.)*

A joint venture is really a legal entity separate and apart from the co-venturers. This entity, which may be a corporation or partnership, is jointly owned and managed by the co-venturers. Common reasons joint ventures are formed include the need to (1) augment a contractor's expertise and capabilities (2) access critical proprietary technology controlled by others (3) keep costs down by using lower cost partners (4) pool financial resources to meet up-front investments (5) gain greater geographic reach to maximize political support and (6) meet customer preferences (e.g. favored firms). Important topics such as the structure of the venture (e.g. corporation vs. partnership), parties' respective shares, management structure, key activities, responsibilities and disclosure and use of technical data and software are usually expressed in a joint venture agreement.

A new business unit, which we will call a "strategic business unit" (SBU), is a segment of a corporation where the parent of one organization has control over its operations. When it has the financial and technical wherewithal to do so, a contractor will commonly create an SBU where there is a need to (1) limit financial, tax or legal liability (2) create a self-contained, "lean and mean" organization focused on one program or contract (3) insulate the rest of the company from onerous government rules or (4) eliminate or reduce general and administrative or other indirect expense allocations to allow for greater price competitiveness.

Cost Allowability

Though legal and business reasons often largely determine the particular type of arrangement, government contractors creating these new entities need to be aware of the accounting, cost allowability and cost allocability issues affecting their creation. The Federal Acquisition Regulations, particularly the cost principles of Part 31, does not separately address cost allowability under contracts performed by joint ventures or SBUs. Rather it is necessary to identify those cost principles that most affect "covered" contracts.

Organization Costs (FAR 31.205-27). This cost principle makes costs unallowable that are in connection with the "organization or reorganization" of the "corporate structure" of a business. Unfortunately, these terms are not defined but it would seem this cost principle would apply to the organization of a *corporate* joint venture or *corporate* subsidiary SBU. On the other hand, costs related to other organizations that do not change the "corporate structure" or alter the rights of security holders would be allowable if reasonable in amount. These would include a *partnership* joint venture or an *unincorporated* SBU.

Individual DCAA auditors may attempt to take a more expansive view making costs of all joint ventures and SBUs unallowable but they should be reminded of the distinctions above that affect the corporate structure and those that do not. Some may also argue

that such organization costs are unallowable because they bear no relationship to the work of the contractor under government contracts. This rationale would be clearly inappropriate when formation of these new arrangements help the contractor compete for and perform their government contracts more effectively and efficiently.

IR&D & B&P Costs (FAR 31.205-18). Changes to the FAR 31.205-18) in the 1990's and subsequent changes to the DCAA Contract Audit Manual (7-1707a) have made IR&D costs in support of cooperative arrangements (of which joint ventures are explicitly included) allowable. Contractors should be assured that effort qualifying as IR&D in the absence of a joint venture will qualify when incurred in behalf of a joint venture.

Interorganizational Transfers (FAR 31.205-26). A joint venture or SBU commonly purchases materials, supplies, and services from its co-venturers/parent and such recovery is limited by this "Material Costs" regulation. The cost principle allows transfers at price (including profit) rather than cost only when (1) it is the established practice of the transferring organization to price its interorganizational transfers at other than cost (2) the item being transferred qualifies for an exemption under FAR 15.804-1 (e.g. established catalog or market prices, commercial item) and (3) the CO has not determined the price to be unreasonable.

Rental Costs (FAR 31.205-36). To the extent a joint venture or SBU leases real or personal property, the rental charges will likely be limited to the "normal costs of ownership" – depreciation, taxes, insurance, facilities capital cost of money and maintenance. The only exception to this rule is for personal property leased from a related organization that has an established practice of leasing the same type of property to unaffiliated entities.

Legal and Other Proceedings Costs (FAR 31.205-47). This is the only cost principle that expressly addresses joint ventures. The principle disallows the costs of litigation between co-venturers unless the disputed agreement or actions are incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the CO. Disallowed costs include not only outside lawyers and consultants but also the directly associated in-house management, accounting, administrative and clerical personnel costs.

Cost Accounting and Cost Allocation Issues

♦ Segments

One important reason contractors want to create joint ventures and SBUs is to have the opportunity to allocate either more or less costs to the entity. Whether the new entity is or is not a "segment" of the co-venturers often determines what costs can be allocated. For example, a segment will receive both direct costs (e.g. interorganizational transfers for goods or services) and indirect charges such as indirect service center costs based on usage (e.g. occupancy, data processing) and residual home office costs. If the joint venture is not considered a segment, it would not qualify for such home office allocations.

Are joint ventures and SBUs segments? For joint ventures, the CAS definition of "segment" is broad enough to give contractors a great deal of flexibility to make their own determinations that will help them meet their cost allocation needs. The definition of a "segment" (CAS 403-30(a)) includes a joint venture where an organization exercises control. But since most joint ventures consist of joint control, the definition does not clearly apply. On the other hand, if a "segment" determination is desirable, another section of the CAS (403-50(e)) provides a broader definition that allows a home office allocation where control is absent but performs certain functions to justify a home office allocation.

An SBU is more clearly a "segment" since it is typically a subdivision of an organization controlled by a home office. However, when an SBU is essentially a "paper entity" without its own employees, assets or liabilities and no direct responsibility for contract performance (e.g. all work is subcontracted out to other organizations), then it is unlikely a segment.

♦ Special Allocation

If the entity is a segment, the co-venturers/parent entities have flexibility in allocating indirect costs to joint ventures and SBUs by either following their established practices for indirect cost allocation or adopting a "special allocation." For example, an organization may track or estimate the costs of services provided by the home office to the joint venture and remove those costs from the pool and allocate them to the segment. Further flexibility is allowed when the entity has unequal ownership, providing the minority contractor the option of

allocating its residual home office costs the joint venture or electing not to do so.

Practically, it should be noted that special allocations need advanced approval by the CO which often encounters delay for pricing proposals. Contractors might price the proposal using the special allocation method assuming approval before contract award and if later not approved, the contractor must revert to its established practice resulting in more cost being allocated than planned. Alternatively, the contractor may price the new work using its established practices and to avoid potential defective pricing allegations, will divulge the intent to adopt a special allocation.

♦ Allocation of IR&D & B&P Costs

When IR&D & B&P costs are incurred before the entity is created, two choices exist: (1) Since no segment exists, the co-venturer/parent is justified in taking the position that IR&D costs should be allocated in the normal manner to other segments with no allocation to the new joint venture/SBU segment. CAS 420.50(e)(2) justifies this position (2) If the segment is established during the same cost accounting period, it can allocate the costs to all segments including the new one. This second alternative runs the risk of not recovering these costs if contract award is not during the same cost accounting period.

CAS 420 dictates that IR&D & B&P costs accumulated at the home office will be allocated to its segments in two steps: first, direct assigning those costs to a specific segment when the costs can be identified with it and then allocating the remaining amount to all other segments in the same way it allocates its residual home office costs. Sometimes when an entity supports only one contract or product line, it may be that ongoing IR&D or B&P costs do not benefit those limited items as much as other segments or at all. When this occurs, they will likely be required (or may be entitled) to seek a special allocation that will allow less home office IR&D/B&P costs to be allocated to the joint venture.

If a joint venture/SBU segment incurs or is assigned IR&D/B&P costs without yet receiving a contract, then it could be accumulating these costs with no vehicle for recovering them. Opportunities for recovery are limited because FAR 31.205-18 and CAS 420.40(f) as well as GAAP usually require current-year expensing. An exception is allowed for *deferred* IR&D recovery of current expenses but only if it developed a specific product, at its own risk, in anticipation of recovering development costs in the sale of the product and, in addition (1) the total amount of IR&D costs are identifiable (2) the proration of costs are reasonable (3) the contractor had no other government business or if it did, it chose to not allocate IR&D costs to government contracts (except for prorating specific costs) and (4) no costs of current IR&D programs are allocated to government work.

SOME BASICS ON PATENT RIGHTS

(*Editor's Note. Protecting intellectual property is one of the hottest areas we encounter lately. It is certainly a very broad area with an army of specialists concentrated in the field. We thought it would be a good idea to provide some basic insight for the non-specialist so we selected one key area of intellectual property - patent rights. We used a couple of recent articles in the June 2007 and March 2008 issues of the Briefing Papers as our primary sources, both of which were written by W. Jay DeVecchio of the law firm of Jenner & Block LLP.*)

There are various forms of intellectual property and intellectual property rights that may be relevant to government contracts. Developing computer software or hardware may result in *trade secrets* that are protectable as "restricted rights" for software or "limited rights" in technical data. These software and data are also subject to *copyright protection*. If the underlying development gives rise to "inventions" then *patent* rights may result. The categories of intellectual property are distinct from each other under the regulations but they may arise from a common set of events. Though discussing each of these are beyond the scope of any one article, we have decided to discuss patent rights since those are most affected by recent court, even US Supreme Court, decisions.

Patent Rights Generally

Broadly speaking, patent laws cover inventions (discoveries) of new, nonobvious and useful things, processes and designs. In the words of the law patentable discoveries include "new and useful process, machine, manufacture or composition of matter or any new and useful improvement" as well as "any new, original and ornamental design for an article of manufacture." There are some limits on the scope of what is patentable such as laws of nature (e.g. gravity), physical phenomena (ice) and abstract ideas (e.g. trip to the moon). However, application of laws of nature are patentable (anti-gravity machine). Also

mathematical algorithms may not be patentable standing alone but may be when incorporated into a process such as a computer program.

When you meet the qualifications for patentability, you then may obtain a patent which in the US provides a legal monopoly on the invention for 20 years. That means, in theory, no one else may make, use, sell or reverse engineer your invention. In practice, the monopoly given is only as good as your ability to police your invention and to sue those who infringe on it, remembering your patent may be a target for others to invent around. This raises the need to decide whether to patent the invention or hold it as a trade secret. Trade secret disclosures and monopolies are largely in your control and the decision should be based on consideration of the following: (1) Is the government the only market? If so, there may be less reason to patent because the government can use the invention or have your competitors do so (2) How easy is it to reverse engineer? If easy, a patent may be best while if not, a trade secret might be better (3) What is your ability to police and litigate patent infringement as opposed to controlling trade secrets?

Applicability to Government Contracts

The question of what is patentable in the context of government contracts means recognizing that inventions may occur during performance of a government contract, particularly ones for research, design or development which, in turn, affects the allocation of patent rights between the government and the contractor. Historically, government agencies simply took title to inventions that arose during contract performance but Congress recognized this practice was a disincentive to developing and commercializing of technology. This led to the Bayh-Dole Act of 1980 which grants the right of contractors to retain title to inventions developed under contracts with the government obtaining a nonexclusive, irrevocable paid-up license. This law was incorporated into the FAR Subparts 27.2 and 27.3 with implementing clauses at FAR 52.227-1 through 13. The Defense Department follows the FAR closely in its DFARS regulations while the Energy Department and NASA have different and more comprehensive requirements.

The triggering event for determining the party's rights is whether there is a "subject invention" which the FAR defines as (1) an invention (2) conceived or (3) first actually reduced to practice in (4) performance of a contract or subcontract. The fourth condition requires there to be a nexus between the invention and work performed which becomes an issue of fact that varies with both the nature of the work and breadth of the contract. *Invention* is defined differently in the FAR than in patent statutes where here it is "any invention or discovery that is or may be patentable or otherwise protectable" under the patent code. The general principle of c*onception* is that an invention must be sufficiently concrete in the mind of the inventor that is could be reduced to practice so there usually needs to be some physical manifestation of the idea (e.g. internal development record, lab notebook). It's a good idea to make sure your company has procedures that rigorously and systematically document conception or reduction to practice. In essence *reduction to practice* occurs when an invention has been embodied in some form that demonstrates its "workability" which for simple inventions may be discernable merely by looking at it while in others it may be tested in labs or tested in actual operating conditions (e.g. aircraft).

If something is a subject invention, it fits within the allocation of the three patent rights clauses – FAR 52.227-11 (used primarily by small businesses or nonprofits), 52.227-12 (large businesses) and 52.227-13 (infrequently used). These clauses must be flowed down to all subcontractors regardless of tier level that are performing experimental, developmental or research work. Along with the standard data rights clauses, the flowdown patent rights are intended to allocate rights and obligations between the subcontractor and government, not between the subcontractor and prime.

A couple of relevant modifications have recently been made: (1) Though not changed in substance, the FAR 52.227-12 clause was deleted from the FAR and relocated to DFARS 252-227-7038 since DOD was apparently the only agency that used it and (2) to avoid the common changes made to subcontract boilerplate clauses where references to the "Government" are made to read "Contractor" and "Contractor" to "Subcontractor" the FAR was changed to make these improper changes to mean flow down through the tiers to the government and not by virtue of a flowdown, to the higher tier contractor.

♦ Disclosure

The rights the government obtains to a subject invention depends first on the nature and timing of the contractor's disclosure. If a company first conceives or reduces to practice an invention under a government contract then it must disclose it to the government promptly in accordance with the contract requirements. If it makes this disclosure, then the company may elect

to keep title to the patent with the government getting a "Government purpose" license in the invention.

The disclosure requirements are spelled out in the patent rights clauses identified above. For those companies not small business or nonprofits, FAR 52.227-12 (now DFARS 252-227-7038) requires the contractor to initially disclose the invention to the CO within 2 months after the inventor discloses in writing to contractor personnel or within 6 months after contractor becomes aware of the invention, whichever occurs earlier. The two month trigger assumes someone either within the organization or outside (e.g. external patent counsel) is responsible for patent matters. If not, the 6 month period applies by default.

The nature of the disclosure is in the form of a "written report" identifying the contract under which the invention was made, the inventor and technical details sufficient to convey "a clear understanding…of the nature, purpose, operation, and physical, chemical, biological or electrical characteristics of the invention." Additionally, the disclosure must identify and describe any publication, sale or public use of the invention.

DOD has a standard form – DD Form 882 – that should be used under Defense contracts and subcontracts but it should be clear that whatever format is used, the requirements apply to all government contracts. Having a reporting process is important not just for reporting sake, whether or not a patent is taken out, but it largely determines whether an item, component, process or software was developed at private or public expense at the *lowest practical component level* because that becomes the touchstone for limiting or restricting government rights in technical data and computer software.

If a contractor discloses an invention but elects not to retain title the contractor still will retain a license to the patent. However if it fails to disclose and if the government acts within 60 days after learning of the contractor's failure to disclose, then it looses all rights to the invention and receives no license. The prudent course is for a contractor concerned about its patent rights to disclose all inventions, realizing the FAR definition applies to inventions that "may" be patentable. Stated differently, when in doubt about whether an invention is patentable, disclose it. However, the result of a development effort is plainly not an invention and hence need not be disclosed unless it is protectable as a trade secret. There is one caveat to these principles – if the government is the only market for the invention and there is not likely to be any commercial application, then a patent arguably has little value to the contractor since the government in all circumstances will have at least a very generous license.

♦ Election to Retain Title

Following disclosure requirements the next step is for the contractor to elect to retain title or not. Under the patent clause we have been discussing, this election must occur within 8 months of the initial disclosure (either the 2 month or 6 month disclosure) and is often made by companies at the time of initial disclosure. Even if it declines to take title the contractor will still retain a "nonexclusive, royalty free license throughout the world" in each invention This license extends to the contractor's domestic subsidiaries and affiliates and includes the right to grant sublicenses. However, it is not transferable without the approval of the agency except as part of a corporate succession. The government may obtain titled notwithstanding a contractor's election if the company fails to file an initial patent application, in the United States, within one year of election or fails to file for foreign patents within 10 months of the initial US patent application. The government may also obtain title if the contractor "decides not to continue the prosecution of any application for, to pay the maintenance fees on or defend" a patent on an invention.

♦ Continuing Obligations

In addition to the disclosure and election requirements, the FAR requires contactors to file continuing reports. For example, the clause applying to non-small businesses requires (1) interim reports every 12 months form the date of contract listing the subject inventions (2) a final report, within 3 months after completion of the contract work, listing all subject inventions and listing all subcontracts at any tier level containing a patent rights clause and (3) periodic reports on utilization of a subject invention or efforts at obtaining utilization that are made by the contractor or its licensees or assignees. In addition, if it elects title, the contractor must file patent applications and pay for maintenance fees. In the event the contractor fails to do so, the government may take title although the contractor made a proper disclosure but it will still retain a broad license.

Authorization & Consent

It makes sense that if a contractor is performing work for the government there be limits on the ability of a third party to sue the contractor for infringement and

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as a result stop government performance. A statute has been provided to avoid this problem by providing if a patented invention is used "by or for the United States" then (1) an exclusive court jurisdiction exists in the US Court of Federal Claims for a suit by a patent owner against the government, not against the contractor, where remedies are money damages not injunction against performance and (2) an alleged infringing contractor has an affirmative defense for action by a patent holder.

There is a two part test to determine the existence of authorization and consent (A and C) – the invention has to be used "for the government *and* with the authorization or consent of the government." A and C can be implied or express. Authorization and consent can be implied by, for example, CO direction, specifications or drawings that necessitate patent infringement or government knowledge of the infringement. Express authorization, which is more common, is found in the clause FAR 52.227-1, Authorization and consent.

Patent Indemnity

Notwithstanding A and C, a contractor may ultimately be liable to indemnify the government for any damages. FAR 52.227-5 addresses indemnification where the contractor is to be promptly notified of any infringement action by the government. The FAR instructs the government that the Patent Indemnity clause is not to be used when there is broad A and C or in contracts for supplies or services that are uniquely governmental – clearly not offered or sold to the public in the competitive market. Prime contractors and subcontractors should look at their flowdown provisions to ensure indemnity provisions are used appropriately and should reject them if they are not.

Patent Rights vs. Data Rights

Though the same development activity under a contract may give rise to both a subject invention and to technical data or computer software where the government may obtain rights, these two forms of intellectual property rights are very distinct under the regulations. The patent rights and data rights license rights are contained under different clauses. Contractors should be aware there are different disclosure rules and marking requirements under patent rights and data rights clauses. If these requirements are not recognized contractors risk losing either its right to patent title or license or its ability to assert limited or restricted rights for items that were developed at private expense prior to a government contract.

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