

Raytheon Wins at ASBCA (Again) Part 3

Written by Nick Sanders
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In Part 1 of this analysis of the recent Raytheon victory at the ASBCA, we outlined the issues—which involved multiple appeals covering multiple issues across multiple years at both the Raytheon Corporate Home Office and its Missile Systems business unit. We also discussed the first major issue: the allowability of Raytheon’s premium class airfare. In Part 2 we discussed the treatment of two similar issues: Raytheon’s “Corporate Development” and “Government Relations” costs.

Here’s [a link](#) to the ASBCA decision, in case you want to review the 100+ page decision. (Hint: you really should.)

In Part 3, we are going to discuss the treatment of patent costs incurred at Raytheon Missile Systems (RMS).

Let’s get to it.

Patent Costs

FAR 31.205-30 (“Patent Costs”) controls the allowability. In a nutshell, the cost principle says that patent costs required by a government contract are allowable and “general counseling services relating to patent matters, such as advice on patent laws, regulations, clauses, and employee agreements,” are allowable. Pretty much all other patent-related costs are not allowable. (But read the cost principle for the details, please.)

Raytheon had a policy to tell employees how to treat any inventions that might be produced on company time. (As we are learning from writing this series of articles, Raytheon seems to have had a policy for just about everything under the sun. Given how Raytheon has a near-unbroken string of victories for appealing costs questioned by DCAA, we suggest other contractors might want to consider doing the same.) Raytheon’s policy assumed that any new inventions would be discovered during performance of a government contract, but allowed that such might not be the case. The policy contained a form that the inventor was to complete and submit it to a committee for review. Importantly, the policy did not solely address patents; it addressed any intellectual property that might be created.

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The Board described Raytheon's policy as follows:

Form 10-5876 requires the inventor to describe the invention technically and to explain how it is new. It also requires identification of the labor charge code applicable to the time the inventor spent conceiving of or reducing the invention to practice. If the invention was discovered separately from government contract work, the inventor must identify the charge code for the company-funded program or overhead. If the work was performed under a government contract, the invention disclosure reports the contract number and the applicable FAR and Defense Federal Acquisition Regulation Supplement (DFARS) patent rights clauses.

(Internal citations omitted.)

The committee evaluated the invention disclosure to determine whether Raytheon should file for a patent or treat the intellectual property as a trade secret, innovation award, or a different type of intellectual property. If the committee decided not to seek a patent, the invention was not disclosed to the public and remained confidential. If the committee decided to seek a patent, the invention disclosure was submitted to another function for handling. According to Raytheon, at the point where the committee decided to seek a patent, the associated costs become subject to the 31.205-30 cost principle. All costs incurred prior to that point were not subject to the cost principle, because nobody knew whether or not they were related to a patent. Costs incurred before a decision to submit for patent processing were just regular (allowable) overhead costs, according to Raytheon.

The Board noted that, in 2007, 149 invention disclosure forms were submitted for committee review at RMS. Of that amount, 110 (74%) were approved for patent processing. Of the 110 patents that were processed in that year, 26 (24%) were related to a government contract (*i.e.*, allowable), and the remainder were not (*i.e.*, unallowable).

If you've read the previous two articles on this appeal, you will not be surprised to learn that DCAA (and DCMA) disagreed with Raytheon's position on cost allowability. DCAA's position, according to a quote in the Board's decision, was that "all effort incurred by RMS employees to prepare, review, and approve/disapprove invention disclosures *for patent applications* to be

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patent costs’.” (Emphasis in original.) According to the Board’s Findings of Fact (#122 and #123)—

DCAA based its questioned amount of \$96,701 in ‘engineering labor costs claimed in the engineering overhead pool for RMS *patent activities* not required by contract.’ DCAA speculated that the actual costs incurred could be ‘substantially more.’ (emphasis added) DCAA concluded that RMS had violated CAS 405 by failing to identify adequately and exclude the expressly unallowable patent costs.

DCAA replied [to Raytheon’s objections] that, unlike RMS’ practice, FAR 31.205-30 did not exclude costs of invention disclosures not submitted for patent approval, or protected as intellectual property in some other way, from its unallowable cost restrictions.

The Board also noted that, perhaps because of the long delay associated with DCAA’s audit (the audit started in 2008 and concluded in 2014), the agency’s position had changed over time. Initially, the auditors had said there was “insufficient audit evidence” to support questioning the costs, but that initial position didn’t stop the agency from overruling the auditor’s judgment in the final report. (GAGAS violation, anybody?) In the end, the audit report questioned \$96,701 of claimed indirect engineering labor costs and the DACO hit RMS with a CAS 405 noncompliance because Raytheon should have known that those costs were *expressly* unallowable. (Notwithstanding the fact that a different group of DCAA auditors at a different Raytheon business unit had found similar costs, in similar circumstances, not to be unallowable at all.)

Raytheon had attempted to create a “bright line” for cost allowability, similar to its treatment of Government Relations and Corporate Development costs. (See the Part 2 article for details.) In Raytheon’s view, it was not until it was clear that a patent would be pursued that the costs became subject to the 31.205-30 cost principle. In contrast, the DCAA/DCMA view was that all costs associated with a patent, including preparation of invention disclosures (and the Raytheon disclosure form) were expressly unallowable unless required by a government contract.

The Board disagreed with both positions.

According to the Board—

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The government misreads FAR 31.205-30 to apply more broadly than it does, and it adds language to the regulation that is not there. The regulation certainly does not specifically define 'preparation' of 'invention disclosures' 'as an initial but essential step in the [p]atent application process' (whether or not a patent is ultimately submitted, rejected, or obtained). Moreover, it does not state that all invention disclosures are patent costs, regardless of whether patents are involved. Indeed, some of RMS' invention disclosures are associated with forms of intellectual property other than patents, or with RMS' recognition of invention efforts that did not lead to patent applications. It is not clear whether such costs are among the costs at issue.

On the other hand, Raytheon also misreads FAR 31.205-30. RMS does not consider the costs to discover new inventions, of preparing and submitting invention disclosures, of a manager's review of invention disclosure forms, or of [the committee's] review to be patent costs, on the ground that there is not yet any patent and RMS does not know whether there will be one. RMS defines patent costs to be those occurring after the [committee] decides to pursue a patent. ...

Raytheon's interpretation of FAR 31.205-30 is unreasonable. Under its interpretation, patent-related invention disclosure costs would never be unallowable, even if no government contract requirement were involved, and the FAR's reference to allowable patent invention disclosure costs would be superfluous.

(Internal citations omitted.)

The Board interpreted the cost allowability provisions of 31.205-30 as follows:

The reasonable interpretation of FAR 31.205-30 is that, when patents are involved, the costs of the associated invention disclosure and review are patent costs. They are allowable if incurred due to government contract requirements. Otherwise, they are not allowable. There is no exception for costs incurred during the invention disclosure preparation and review process prior to the decision to pursue a patent. If patents are not involved, the invention disclosure and related costs are allowable.

Even though Raytheon's interpretation was rejected, it still won. The Board found that the

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DACO had questioned costs that were likely to be allowable. The Board wrote:

It appears that the \$96,701 disallowed amount at issue improperly includes costs for subject inventions and might include costs for non-patent invention disclosures and review that are allowable. The Board cannot determine from the record what the proper amount of unallowable costs should be. This is a failure of proof by the government leading us to sustain the appeal.

In a final footnote the Board added this nugget:

In any case, if the government could have established the proper amount of unallowable costs, its various treatments of FAR 31.205-30, including its overly broad interpretation in this appeal, would have undermined its contention that the invention disclosure and review costs at issue were 'expressly unallowable' under FAR 42.709-1(a)(1). The government's demand for a level one penalty was unwarranted.

(Internal citations omitted.)

So how should Raytheon enhance its policies and controls to address the Board's finding that it has misinterpreted the cost principle?

If we were advising RMS and Raytheon—which, to be clear, we are not nor do they need any outside expertise in this area—we would suggest that all costs related to invention disclosures be treated as being unallowable. Perhaps the costs of preparing and reviewing the invention disclosure forms could be segregated in a separate Statistical Order. As the committee decides which inventions will be processed for patents (which is about 74% of them), the costs associated with the remaining 26% could be subsequently transferred to an allowable indirect account. Then, for the patentable inventions, since about 24% of those were required by a government contract, then those costs could also be identified and transferred to an allowable account (whether direct or indirect as circumstances dictate). Whatever would be left over would have been properly classified as being unallowable.

Alternately, RMS and Raytheon could record all costs as being allowable but perform a

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year-end analysis as above, and self-disallow or “withdraw” costs related to patents that were not required by a government contract. Either way would seem to work.

But we are not done yet. The ASBCA decision also dealt with outside patent costs.

External Patent (Legal) Costs

According to the Board: “Raytheon withdraws the ‘vast majority’ of patent costs it pays to its external counsel to prepare and submit patent applications, but it charges the government the costs associated with the preparation of its patent application if it considers the patent to be a ‘subject invention’ conceived of as a requirement of a government contract under FAR 31.205-30. These costs are charged to the government as indirect costs and are not charged directly to the contract.”

The Board noted that the DCMA DACO was concerned about the looming statute of limitations deadline, and therefore he and DCAA did not review the documentation that RMS provided when DCAA questioned 100% of its outside legal costs associated with patent processing. (Another GAGAS violation, anybody?)

The Board described the parties’ arguments as follows—

... DCMA contends that FAR 31.205-30(a) requires that, in order to qualify as direct costs of government contracts, Raytheon must prove that they are ‘literal line item requirements’ of the contracts. Additionally, even if Raytheon were able to demonstrate that the outside patent legal costs were required by government contracts, the costs should have been charged directly to the government contract involved, in accordance with FAR 31.201-2(a)(2), FAR 31. 201-4, and CAS 402. They were not and are therefore unallowable.

Raytheon alleges that the costs at issue are expressly allowable because each of the disallowed invoices was associated with a subject invention developed under a government contract. Raytheon asserts that RMS met its obligation under FAR 31.201-2(d) to maintain documentation supporting the allowability of its patent legal costs *but the government chose to*

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ignore the submitted documentation due to its statute of limitation concerns

. Raytheon further asserts that DCMA has not met its burden to show that the costs are unallowable under FAR 31.205-30, which does not limit its allowability provisions to direct costs. It adds that, under the government's 'line item' contention, 'other than contracts for the purpose of acquiring patent application filing services, it is difficult to fathom what costs would be allowable' Regarding allocability, Raytheon urges, and we have found, that, in accordance with CAS 402, RMS has consistently classified all of its legal costs as indirect expenses. This includes the legal costs for subject inventions, which benefit not just the government contract under which they were discovered but benefit Raytheon as a whole because it owns the patent. Therefore, the outside legal patent costs in question are properly allocable as indirect costs.

(Internal citations omitted; emphasis added.)

The Board agreed with Raytheon, finding that the costs in dispute were allowable because they were required by a government contract. The Board also disposed of the government's allocability argument (as it should have) writing—

We conclude that Raytheon and RMS' regular disclosed practice of charging outside legal costs as indirect costs meets CAS 402's consistency requirements and was proper under the circumstances of this appeal. All of the outside legal patent costs at issue are allowable and allocable as indirect costs.

That wraps up the patent cost allowability (and allocability) portions of the decision. In the next (and final) article, we'll talk about the remaining issues, including costs associated with recruiting and costs associated with variable compensation.