

Frankenstein's Monster: Data Rights Changes Adopted In The National Defense Authorization Act For Fiscal Year 2011

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A great deal of discussion has transpired regarding recent legislation that reportedly could alter significantly the established “follow-the-funds” test used for the allocation of intellectual property rights in data developed under a government contract. The legislation involved is a provision of the **National Defense Authorization Act for Fiscal Year 2011 (the “Act”)**, signed into law on January 7, 2011. In particular, Section 824 of the Act provides “Guidance Relating to Rights in Technical Data” and, more importantly, amends **Section 2320(a) of Title 10** of the United States Code, the provision that defines the allocation of rights in intellectual property under Government contracts.

Unfortunately, the amendment adopted in the bill is clearly flawed. The provision, read literally, makes no sense. Depending on what Congress actually intended to impose, the change is either a major “sea change” in the way rights in data are to be allocated, or it is merely a refinement and expansion of current law dealing with *de minimis* activities. Many are raising alarms regarding the potential impact of the change, and such concern may be warranted. On the other hand, consideration of the legislative history leading to the provision suggests that only a modest change was intended but was transmogrified to something akin to Frankenstein’s monster in the reconciliation of the House and Senate versions of the Act.

As enacted, the Act seems to require, at least to some extent, that **Independent Research and Development (“IRAD”)** costs and Bid and Proposal (“B&P”) costs be treated as “government expense” in applying the data rights follow-the-funds test. As such, the government would be allocated, at a minimum, a Government Purpose Rights License in data related to an item or process developed under an IRAD or B&P project or, more likely, an Unlimited Rights License in those data. This, obviously, would be a marked departure from established principles that define IRAD and B&P costs as “private expense.” Indeed, the treatment of IRAD and B&P costs as “private expense” has its roots in the earliest interpretations of the rights in data provisions set forth in the Armed Services Procurement Regulation of the late 1950s and 1960s. This historic treatment of IRAD and B&P costs even avoided the assault on the Defense Federal Acquisition Regulation Supplement (“DFARS”) data rights provisions adopted in the late 1987-88 time period (only to be reversed in the 1995 revisions).

In relevant part, the Act adopts the following changes to 10 USC §2320(a):

(b) Rights in Technical Data- Section 2320(a) of title 10, United States Code, is amended—

(1) in paragraph (2)(F)(i)—

(A) by redesignating subclauses (I) and (II) as subclauses (II) and (III), respectively; and

(B) by inserting before subclause (II), as so redesignated, the following new subclause (I):

(I) rights in technical data described in subparagraph (A) for which a use or release restriction has been erroneously asserted by a contractor or subcontractor;'; and

(2) in paragraph (3), by striking 'for the purposes of definitions under this paragraph' and inserting 'for the purposes of paragraph (2)(B), but shall be considered to be Federal funds for the purposes of paragraph (2)(A)'.

Act, Section 824 (emphasis added).

Incorporating the required changes into the relevant portions of 10 USC §2320(a) results in the following requirement:

§ 2320. Rights in technical data

(a)

(1) The Secretary of Defense shall prescribe regulations to define the legitimate interest of the United States and of a contractor or subcontractor in technical data pertaining to an item or process....

(2) Such regulations shall include the following provisions:

(A) In the case of an item or process that is developed by a contractor or subcontractor~~exclusively with Federal funds~~ (other than an item or process developed under a contract or subcontract to which regulations under section 9(j)(2) of the Small Business Act ([15 U.S.C. 638 \(j\)\(2\)](#)) apply), the United States shall have the~~unlimited right~~ to—

(i) use technical data pertaining to the item or process; or

(ii) release or disclose the technical data to persons outside the government or permit the use of the technical data by such persons.

(B) Except as provided in subparagraphs (C) and (D), in the case of an item or process that is developed by a contractor or subcontractor exclusively at private expense, the contractor or subcontractor may restrict the right of the United States to release or disclose technical data pertaining to the item or process to persons outside the

government or permit the use of the technical data by such persons.

* * * *

*(E) In the case of an item or process that is developed **in part with Federal funds and in part at private expense**, the respective rights of the United States and of the contractor or subcontractor in technical data pertaining to such item or process shall be established as early in the acquisition process as practicable (preferably during contract negotiations) and shall be based upon negotiations between the United States and the contractor, except in any case in which the Secretary of Defense determines, on the basis of criteria established in the regulations, that negotiations would not be practicable....*

*(3) The Secretary of Defense shall define the terms “developed”, “exclusively with Federal funds”, and “exclusively at private expense” in regulations prescribed under paragraph (1). In defining such terms, the Secretary shall specify the manner in which indirect costs shall be treated and shall specify that amounts spent for independent research and development and bid and proposal costs shall **not** be considered to be Federal funds **for the purposes of paragraph (2)(B), but shall be considered to be Federal funds for the paragraph (2)(A).***

10 USC §2320(a), Subparagraph (3) modified to capture the changes adopted by the Act (emphasis added).

The revision seems to maintain the traditional treatment of IRAD and B&P costs as “private expense” in those situations in which the development cost was accomplished exclusively at private expense (Subsection 2(B)), but alters the traditional definition in those situations in which the development cost was accomplished “exclusively at government expense” (Subsection 2(A)). The modification is silent as to any impact on so-called “mixed funding” development involving both private and federal expense contributions. The problem with this approach, of course, is that IRAD and B&P development efforts are part of what needs to be defined in making the “private” and “federal” expense determination. The absurdity of the new provision is best illustrated by attempting to apply its requirements to an item, component, or process developed entirely through an IRAD or B&P effort. The only answer to the question of whether such an item, component, or process was developed “exclusively at private expense” or “exclusively at government expense” is “yes.”

Assuming that what is stated is not what Congress intended, the question remains: What did Congress intend? Did Congress mean to make a fundamental change to the 50+ year old follow-the-funds test as it pertains to IRAD and B&P costs? A review of the very limited legislative history of Section 824 of the Act at least suggests that Congress had no such “sea change” in mind. Section 824 has its genesis in the Senate. The Senate adopted a relatively modest change to 10 USC §2320(a). The House bill had no comparable provision. The Senate bill proposed amending subparagraph (a) of §2320 to read as follows:

§ 2320. Rights in technical data

(a)

(1) *The Secretary of Defense shall prescribe regulations to define the legitimate interest of the United States and of a contractor or subcontractor in technical data pertaining to an item or process....*

(2) *Such regulations shall include the following provisions:*

(A) *In the case of an item or process that is developed by a contractor or subcontractor exclusively with Federal funds **without a significant contribution by a contractor or subcontractor** (other than an item or process developed under a contract or subcontract to which regulations under section 9(j)(2) of the Small Business Act (15 U.S.C. 638 (j)(2)) apply), the United States shall have the unlimited right to...*

* * * *

(3) *The Secretary of Defense shall define the terms “developed”, “exclusively with Federal funds”, “exclusively at private expense” **and “significant contribution by a contractor or subcontractor”** in regulations prescribed under paragraph (1). In defining such terms, the Secretary shall specify the manner in which indirect costs shall be treated and shall specify that amounts spent for independent research and development and bid and proposal costs shall not be considered to be Federal funds for the purposes **of paragraph (2)(B).***

Senate Bill S.3454 (emphasis added).

The Senate language in general reaffirms the traditional treatment of IRAD and B&P costs as representing “private expense” in the application of the follow-the-funds test. At the same time, it treats as “government expense” (or, alternatively, renders inapplicable) those contractor-incurred IRAD and B&P costs that do not represent a “significant contribution” to the development of an item, component or process. This proposed change, while significant and the potential source of important issues, does not represent the “sea change” feared by many. Unfortunately, how Congress got from the Senate proposal to the language in the Act is largely undocumented. The “Joint Explanatory Statement to Accompany H.R. 6523 [the adopted House version]” states only:

Guidance Relating to Rights in Technical Data (Sec. 824)

The Senate committee-reported bill contained a provision (sec. 824) that would require the Secretary of Defense to revise guidance on rights in technical data to promote competition and ensure that the United States is not required to pay more than once for the same technical data.

The House bill contained no similar provision.

The agreement includes the provision with a clarifying amendment.

The issue that the Senate provision seems to have been drafted to address relates to what has been called the “oldest game available to contractors.” In brief, that “game” is the product development strategy of analyzing a particular product to identify the single component or process that is the key to proper functioning of the overall product or otherwise provides the contractor with a clear technological competitive advantage. Government funds are then sought and utilized to “develop” all portions of the product except for the key component or process. For the development of the key component or process, only private funds are used – generally IRAD or B&P funds. As a result of this strategy, if the government wishes to buy the end item, it must “sole source” the procurement to the company that controls the data rights to the key component or process. Thus, an important limitation is placed on the government’s ability to compete future procurements – a phenomena that the DoD and Congress apparently find, at least to some extent, to be bad policy. See, e.g., Joint Explanatory Statement to Accompany H.R. 6523, page 446, *supra*. The proposed Senate change to 10 USC §2320(a) would attempt to assure that any partial funding of an item, component, or process that is relied upon by a contractor to restrict the government’s rights to compete the end item involves private expenditures that represent a “significant” contribution to the overall use or functioning of the item.

What Can Be Done To Clarify the Amendment?

The Defense Federal Acquisition Regulation Supplement Council (“DFARS Council”), the body charged with implementing the new law through an amendment to the DFARS, established a “DFARS Case” on January 19, 2011 to accomplish the required new, amended coverage. A DFARS Case is assigned to a working group that gathers relevant data and research and drafts proposed new regulations. A report was due from the working group to the Council on April 13, 2011. It is possible, but unlikely, that a draft proposed regulation could be published in the Federal Register soon thereafter. As you know, if a substantive regulation change is proposed, the public must be permitted an opportunity to comment on the proposed new regulation. Unfortunately, because the change is based on an act of Congress, the Council may decide that it has little ability to substantively stray from the language of the Act in adopting a proposed regulation. Well founded criticism, however, likely will cause the DFARS Council to delay implementation and cause the Council to seek, via the Office of the Secretary of Defense, corrective or clarifying legislation.

Clearly the most effective method of seeking an amendment of Section 824 of the Act is through trade associations. Both the National Defense Industry Association and the Public Contract Law Section of the American Bar Association, for example, are active in responding to proposed regulatory amendments. Moreover, individual contractors may have the resources to lobby Congress directly. All such avenues should be pursued.

What Are the Policy Issues Raised By the Amendment?

There are a number of points that can be made to illustrate the problems with a policy that significantly alters the current bases for allocating rights under DoD contracts. The following summarizes some of the more significant.

1. **Effect on the Development of New Technologies:** There can be little doubt that the change proposed will have a significant impact on DoD contracting companies’ willingness to undertake IRAD projects. Without the ability to protect intellectual property rights through such projects, companies are more likely to insist on direct government reimbursement for their

development efforts. There is little or no incentive otherwise to incur the IRAD or B&P expense. Even if the IRAD or B&P project involves a so-called “dual use” product, a product with a commercial as well as a military application, development of the product as part of an IRAD or B&P effort runs the risk of an allocation of an Unlimited Rights License to the government – a license that largely destroys the commercial value of the product. While an argument can be made that independent development programs might be funded out of non-contract funds (profit, equity, or other private investment), such an approach under typical DoD cost and accounting rules would place the entire development cost on the contractor and the government would gain use of any product utilizing the technology without paying more than the cost to produce the product. Unlike commercial entities and the accounting practices available to them, companies under DoD contracts cannot capitalize and amortize intellectual property costs over the anticipated useful life of the technology or product. Similarly, DoD cost rules would prevent including in any negotiated contract proposal an amount not supported by estimated, future expense as opposed to expended private funded costs. As a result of these limitations, if the essential thrust of Section 824 is implemented, the DoD likely will find that new products and technologies will not be developed unless the associated costs are paid for as a direct cost by DoD. As a further result, many such projects simply will not be undertaken because of limited government funding.

2. **Competitive Marketplace for Intellectual Property:** A correlative impact of the likely outcome discussed above, is the effect on the competitive marketplace for technological development. Under the current treatment of IRAD and B&P costs, a great deal of the decision making regarding which development projects are worthy of pursuit is left to each individual contractor. (A practice under separate attack by proposed regulatory changes such as those related to IRAD reporting; see, e.g., 76 Fed. Reg. 11414 (Mar. 2, 2011)). To the degree that new development efforts, as a result of the impact of the Section 824 policy changes, will need to be directly funded by DoD, greater control of IRAD projects will be vested in DoD. Control of technology innovation will shift significantly. Only those technologies that DoD deems worthy of federal expenditures will be financed. The open marketplace of competing technologies in the military field will be displaced. U.S. defense technology planning increasingly will emulate that of the 1960s and '70s, as well as the that of the former Soviet Union with its 3 year, 5 year, and 10 year structured technology plans. Oddly, such an approach largely was abandoned in the late 1980s and 1990s with the adoption of various procurement policy changes culminating with the Clinton-Gore initiatives to increase U.S. worldwide competitiveness in technological innovation. The changes to the allocation of rights in data adopted by the Act, is a reversion to the prior, micro-management policies of the 1970s and early 1980s that was found to have been counterproductive.
3. **Availability of Commercial Products:** Based on the changes to data rights policy inherent in the Act, commercial sellers at both the prime contract and subcontract levels will be extremely reluctant to accept DoD contracts and subcontracts. Should the new regulations implementing the Act be written aggressively to allocate to the government rights in data related to products developed with IRAD funds, commercial entities will abandon the DoD market. All of the efforts and progress made by the DoD over the last 15 years to attract commercial vendors (see, e.g., “Intellectual Property: Navigating Through Commercial Waters – Issues And Solutions When Negotiating Intellectual Property With Commercial Companies,” Under Secretary of Defense for Acquisition, Technology and Logistics (October 15, 2001) (hereinafter “Navigating Commercial Waters”)) would be squandered and the impact on DoD programs would be dramatic. The following chart, for example, is taken from a report issued by the National Science Foundation and illustrates the likely magnitude of technologies DoD

will find unavailable for its programs.

What this chart demonstrates is that the federal government clearly was the proverbial 700 pound gorilla in sponsoring R&D efforts prior to the 1980s. The chart also demonstrates that while the DoD largely financed its own technology/product development efforts prior to the early 1980's, that phenomenon has changed dramatically over the years. Today it is a very import player, but no longer dominant. As of 2008, close to 70% of all United States R&D expenditures were funded by commercial businesses. Importantly, of the 25% federal government expenditures for R&D, only approximately half were DoD expenditures. See, e.g., *Navigating Commercial Waters*, Forward. Thus, an enormous amount of cutting edge technology is being developed in the private sector without DoD financing. A DoD procurement policy that discourages participation by commercial vendors, particularly those in high technology disciplines, likely will have a major impact on DoD's ability to achieve its procurement objectives. Those companies will not sell their products to DoD under contracts that threaten to allocate to DoD expansive rights in technologies developed in IRAD projects. As a result, critical, advanced technologies and products in such areas as telecommunications, super computers, and software simply will not be available to be used in DoD procurements.

It is not clear how far-reaching changes to the technology policies will extend as a result of the changes adopted by the Act. The thrust of the Act, however, and the proposed changes in control of IRAD reporting suggest a movement back to policies that were abandoned in the '80s and '90s. Like

Frankenstein's monster, the changes seem to have been adopted without considered thought of their long term reach. While focusing solely on apparent short term advantages to the DoD (obtaining greater rights in intellectual property), they ignore likely market reaction and the longer term detrimental effect on (a) U.S. technology policy and (b) DoD's ability to access cutting-edge commercial technologies. The new policies seem to ignore the findings and guidance the DoD expressed in (a) the Under Secretary of Defense for Acquisition, Technology and Logistics [USD(AT&L)] Policy Letter of January 5, 2001 (Subject: Reform of Intellectual Property Rights of Contractors), (b) the USD(AT&L) Policy Letter of September 5, 2000 (Subject: Training on Intellectual Property), (c) the USD(AT&L)] Guidebook "*Navigating Commercial Waters*," as well as (d) Congressional policy decisions reflected in the Federal Acquisition Streamlining Act ("FASA"), The Federal Acquisition Reform Act ("FARA"), and the Information Technology Management Reform Act ("ITMRA"). Common sense would indicate that considerably more analyses and debate should accompany this new policy decision than that which is reflected in the adoption of the Act.

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