

Offsets Loom Large As Defense Firms Sell More Abroad

Law360, New York (September 30, 2013, 5:53 PM ET) -- Traditional markets for U.S. defense contractors are shrinking, as a consequence of sequestration and related budget pressures as well as the wind-down of U.S. military commitments in Iran and Afghanistan, and because European Union countries are reducing their defense expenditures. At the same time, defense spending is on the rise in several regions of the world where security threats are increasing. The greatest increase in regional military expenditures is forecast for East Asia, South Asia and the Middle East. Excluding China and Israel, countries expected to dominate spending on foreign-sourced military equipment include the Republic of Korea, Taiwan, Japan, Singapore, Indonesia, India, the United Arab Emirates, Saudi Arabia, Qatar and Turkey.

Early in 2013, the State Department reported that foreign military sales more than doubled, increasing from \$34 billion in 2011 to \$69 billion in 2012. In recent history, U.S. sales of major defense equipment to foreign countries have been dominated by “Tier I” contractors, such as Boeing, Lockheed Martin, Northrop Grumman, Raytheon, BAE Systems and General Dynamics. Well-publicized examples of high dollar value sales include aircraft and helicopters, air defense systems, maritime security, surveillance systems and armored vehicles. Individual contracts can have very high values; for example, Boeing has an order from India for eight P-8I maritime patrol aircraft worth \$2.1 billion and Lockheed Martin recently announced a \$3.9 billion order for the THAAD area defense system for both the U.S. Missile Defense Agency and the UAE. U.S. companies at “Tier II” and “Tier III” are ramping up their efforts to sell hardware, sometimes as “mission equipment” for the platforms sold by larger U.S. primes. For example, Telephonics supplies radar systems to support the P-8I maritime patrol aircraft that Boeing has sold to India.

An increasing number of U.S. firms are exploring the international markets at the same time that the “majors” are increasing their emphasis. In July 2013, Lockheed Martin formed a new organization, Lockheed Martin International, focusing resources on international customers. Lockheed’s near-term goal is to grow international sales from 17 percent of the company’s total revenue to 20 percent. Lockheed already reports about \$8 billion in annual sales to international customers. In July of this year, Raytheon CEO Bill Swanson told securities analysts that Raytheon was nearing its goal of having foreign sales account for 30 percent of total revenue — up from 26 percent of sales in fiscal year 2012 and 16 percent in 2002.

Sales of U.S. defense supplies and services can occur either on a government-to-government basis, via the “Foreign Military Sales” (or “FMS”) process, or as direct commercial sales that are negotiated between the foreign purchaser and a U.S. contractor. In either case, sales are regulated as to export controls and technology release. And — whether sales are made by FMS or through the commercial route — almost all purchasing countries demand domestic industrial participation or “offset” commitments from the seller. The basic proposition is that the purchasing country insists on a contract

from the U.S. (or other foreign) seller that it will buy from or invest in the domestic resources of the purchasing country.

A basic distinction is between “direct” and “indirect” offsets. While definitions vary somewhat, usually “direct” offsets refer to purchases of military equipment related to the system or item that is the subject of the principal supply contract. “Indirect” offsets may be unrelated purchases of defense supplies and services, though some countries allow or even encourage compensating purchases, investments or other business relationships with nondefense economic sectors. Some countries allow (and others may require) direct foreign investment and technology transfer to build up their domestic defense industry.

Virtually all foreign purchasers of U.S. military equipment have one form or another of required offsets or mandatory industrial participation. In May 2013, the Economist reported that offsets are an accepted practice in 120 countries. There is enormous variety in the offset requirements, operating principles and administration of offset programs. But there are some features that are nearly universal, in principle, though application in practice may vary. U.S. companies of all sizes are well-counseled to understand these principles and to appreciate the business, compliance and legal risks that will flow from the offset commitments that accompany foreign sales. For the larger U.S. companies, already experienced with foreign markets, the challenge is both to fulfill offset and industrial participation requirements already under contract and to satisfy the obligations that come with new foreign business. For companies new to foreign sales, it is vital to understand that offset proposals can figure decisively in foreign company award decisions, and that offset contracts can raise serious management and compliance challenges — and financial risks.

Offsets today represent an enormous financial commitment on the part of the relatively small number of U.S. companies that already have signed offset contracts with foreign sellers. In February 2012, a highly respected international consulting resource, Avascent, estimated that approximately \$214 billion in offset commitments, worldwide, were generated between 2005-2011. Avascent estimated that rising global demand for military purchases will produce another \$225 billion in offset commitments through 2016. Together, existing and predicted offsets represent a half trillion dollar obligation that must be satisfied. The financial and legal risks of offset commitments may not have received much visibility, but as the importance of foreign markets increases, it is certain that the ability of U.S. companies to satisfy their offset obligations will no longer be “below the radar.” It is especially important that public companies active in international defense markets engage in rigorous risk assessment of offset obligations and active management to contain potential liabilities.

The Offset Commitment. Countries vary in setting the amount of required offset as a percentage of the sale price. Canada, along with many development countries, imposes a 100 percent offset requirement. India ordinarily sets a 30 percent minimum — but applied a 50 percent offset requirement to the \$14 billion announced purchase of Rafael fighter aircraft from Dassault. The UAE sets the required offset at 60 percent of the supply contract value. Turkey requires industrial participation or offset of not lower than 70 percent. When a platform is sold and these percentages apply, the result is offset commitments of very large dollar value made to countries whose domestic industrial base may aspire to, but not yet possess, world class competencies. In Korea, an offset memorandum of agreement is required before formation of the main contract, and the offset package is a “key factor” for the selection of the contractor.

The Offset Contract. Offset commitments always are documented by formal agreement between the selling contractor and the buying nation. This is true even where the military equipment may be sold by FMS and the actual equipment supply contract is between the U.S. government and the purchasing country. Official U.S. policy is to have no involvement with offsets, so the U.S. government never is a party to an offset agreement. Thus, in the event of a dispute, there may be little help available to the U.S. seller from the U.S. government, unless the controversy is so serious as to threaten the bilateral relationship between the nations. Terms and conditions of the offset contract may not be negotiable —

or a company must commit to an offset scheme before it knows what terms and conditions can be negotiated. Concepts routine in U.S. commercial transactions, such as limitation of liability, can be unachievable in an offset contract. Dispute resolution is another sensitive point.

National Purposes & Discharge Strategy. Purchasing countries also vary widely in the national purposes they hope to achieve through offsets. Some countries, like Turkey, have very specific objectives for the promotion of domestic military production and development of new technical capabilities. Turkey now emphasizes co-development rather than co-production and maintains tight control over the identity of acceptable Turkish offset “partners.” In India, the purposes are more diffuse. The Ministry of Defence limits the nature of supplies or services that are “eligible” to “discharge” offset obligations (see below) and the attributes of national entities, public or private, deemed “eligible” to be offset “partners.” But there is neither government coordination nor direction as to what choices a foreign seller makes within these limitations. For the most part, foreign countries measure the satisfaction of offset obligations in terms of demonstrable purchase commerce or local investment. But the UAE, for example, is different. It uses what it calls a “hybrid” model of both “inputs” (technology transfer and capital investment, principally) and “outputs” (net profit from new ventures, salaries paid to UAE nationals and export sales).

Foreign Investment. Some countries will permit foreign direct investment (“FDI”), as could occur in formation of a joint venture, for example, to discharge an offset obligation. India recognizes both capital investment and “in kind” contributions, but these are valued differently. India limits FDI to 26 percent in joint ventures with Indian enterprises, notwithstanding continuing foreign objection that foreign investors lack sufficient control or incentive to take the risks of new venture formation. A higher FDI is nominally permitted in adjacent sectors, such as civil aviation and homeland security, but the administrative authorities in India reportedly have not been receptive to granting offset credit for such investments. In contrast, the UAE essentially requires foreign investment (since the principal basis to discharge UAE offset obligations is through the profitability of new ventures), but at least 51 percent must be owned by UAE nationals.

Eligible Offset Partners. Again, countries differ in how they determine which local companies are “eligible” to be “offset partners” from which a foreign seller can purchase discharge offset obligations. India will not credit purchases from defense sector companies with greater than 26 percent foreign ownership, even if all the employees are Indian and all the work is done in India. Turkey removes much of the decision from foreign sellers by giving direction on which Turkish companies are to be put under contract by a foreign seller. Korea similarly identifies expected “Korean Industry Participants” in the RFP and also keeps a list of small and medium enterprises (“SMEs”) from whom foreign sellers are permitted to buy. It can be extremely frustrating to a foreign seller to find that it cannot obtain a defense supply contract without an approved offset plan, while it also cannot gain assurance that the purchasing government will approve the domestic suppliers identified by the seller in its proposed plan.

Eligible Supplies & Services. Most countries allow either “direct” or “indirect” offsets. A few countries, such as Greece, allow only “direct” offsets,” while other countries may set limits on how much of an offset package can be allocated to each category. Poland, for example, requires that “direct” offsets be no less than 50 percent the required value. Many countries seek through offsets to improve self-sufficiency in supply or support of defense articles, and others seek “indigenization” of design and development capability. India’s stated policy allows purchases from military suppliers as well as concerns that make “dual use” items that have both civil and military application; but, in practice, such transactions rarely are authorized in fact. Similarly, India’s stated rules allow credit for purchases of “services” as might include those from software providers, but an interim policy has caused the Indian Ministry of Defence to reject new offset proposals seeking to acquire services, such as research and design and software development, even from Indian companies.

Multipliers. Some countries incentivize certain types of purchases, investments or transfers of

technology by offering “multipliers” of a base value. Objects of such incentives include distribution of work to micro, small and medium size business enterprises, transfer of targeted technologies, full as opposed to limited intellectual property rights transfer, or achievement of export sales from joint ventures receiving investments. Multipliers may range to as high as 8:1, as is applicable in Turkey, for example, for “enabling technology/ability that is requested particularly” by the Turkish government. All too often, it is very hard to satisfy the offset requirements from the purchasing country’s existing industrial base. So, foreign sellers pay great attention to arrangements that will earn the multipliers. Many purchasing countries extend the highest multiplier “premium” for delivery of leading edge military technologies. India offers a 3:1 multiplier where it acquires targeted military technologies “without any restriction and with full and unfettered rights, including right to export.” In this realm, U.S. companies are at a chronic disadvantage versus some foreign competitors; while the U.S. may possess the technology that is most desired by foreign countries, it often cannot be shared with foreign governments under U.S. export rules and technology release regimes.

Term. Especially where the offset requirement is focused on defense related work, it is a very daunting proposition to assemble the combination of investments, partnerships and purchases that will satisfy a large offset commitment. The time allowed for discharge can be critical, because a “gestation” period of some years may be required, e.g., to “stand up” a new enterprise and bring it to necessary world-class standards. At one time, it was typical that foreign governments would make the discharge duration equal to the term of the underlying supply contract. More current practice is to provide an additional year or two, sometimes after the supply contract period, sometimes before, and sometimes both. Again, there is wide variation. The standard term for Australia is seven years; for Saudia Arabia, offset commitments ordinarily must be satisfied within 10 years; Turkey requires completion within a period not more than two years beyond that of the procurement agreement.

Banking & Trading. In some countries, the best or only way to satisfy an offset commitment is to start building a supply chain before realization of a supply contract to the purchasing nation. Where offset credit “banking” is allowed, companies can “earn” offset credits even before they have corresponding obligations to use them and, if they realize more offset credits than they need for a given period, those credits can be in the “bank” for later application or even used to discharge offset obligations related to a different supply contract to the same country. Many purchasing countries now allow banking, though the details vary. India will allow offset credits earned before signing of the main procurement contract only on a pre-approved basis, and provides that banked offset credits remain valid for seven years from the date credits are accepted by the reviewing authority. Turkey will give “pre-credit” in some situations but allows banking for only five years. A few countries allow transfer or trading of credits earned by one company to discharge offset obligations owed by another company on an unrelated contract. Korea may allow banking on a case-by-case basis and limits utilization of the banked offset value only to the contractor, excepting use for the benefit of a subcontractor that participates in the identical acquisition program under offset obligation.

Penalties. Over recent years, purchasing countries have sought to toughen the “teeth” of the penalties that apply should a foreign seller fail to satisfy its offset commitments. In a few cases, a maximum penalty is set as a modest percentage of the total offset contract value, in which case a foreign seller may decide its best business outcome is to pay the penalty. But other countries impose very high penalty amounts, or exact liquidated damages. India applies a maximum penalty of 20 percent and unfulfilled offset commitments are not extinguished by payment of the penalty. Many countries require performance guarantees or bonds and collect penalties as accrued against these instruments. Several countries treat failure to satisfy offset commitments as cause for later disqualification or debarment from future bid consideration.

Verification. A problem of emerging importance, especially in light of a still-festering scandal in India over purchase of “VVIP helicopters,” is how the foreign purchaser can satisfy itself that the amounts submitted to discharge offset commitments represent bona fide purchases or investments. A related

concern is that credit should be given only for “value added” in country and not, for example, for work that may be subcontracted by an indigenous offset partner to the selling prime or other foreign companies. To illustrate, for offsets in the nature of direct purchase and/or export of eligible products, India determines value addition by subtracting the value of imported components and any fees or royalties paid. We are seeing increasing efforts on the part of a number of companies to require documentation of claims of offset discharge and increasing attention to verification of those claims. This can prove difficult where the purchasing nation has modest acquisition infrastructure and limited trained acquisition and oversight personnel to review and approve submissions.

Changing Partners & Other Relief. Almost always, offset contracts are awarded on the basis of offset plans that are submitted by the foreign seller before execution of the main supply and offset contracts. These plans typically identify prospective offset partners, the nature of work they are to perform, services or supplies to be purchased, expected value, planned investment details, and the like. In the real world, however, especially when sales are made to developing economies, some listed offset partners prove unable to meet their requirements or suffer delays. While some countries allow modification of offset commitments to permit substitution or addition of offset partners, these modifications can be very difficult to achieve in practice. This presents a great conundrum for U.S. companies when the offset obligation remains fixed in amount — and is subject to penalties — but approval cannot be obtained to respond to individual supplier problems.

Anti-Corruption Risks. Offsets historically have been identified as an area rife with corruption risk. Some countries are practically “off limits” for U.S. sellers because of the excess risk that offset contracts cannot be obtained without corruption. TRACE International has spotlighted areas of risk in its February 2013 report, concluding that 30 percent of governments that use offsets “fail to impose any due diligence or auditing requirements on their contracts” and that transparency concerning offset contracts is “very restricted at best in 60 of these countries.” The VVIP helicopter scandal in India involves allegations that approximately \$65 million was funneled through middlemen and phony offset partners to pay bribes to Indian Army and other officials. Worse, in some countries, it is all too much the routine, still, that government bureaucrats or higher officials expect to receive under the table compensation for performing their ministerial duties or making discretionary decisions. Such risks are intolerable to U.S. firms and other ethical international companies as a core matter of enterprise integrity. Moreover, many sellers of defense supplies or services are subject to reporting and/or enforcement obligations under the U.S. Foreign Corrupt Practices Act and the U.K. Anti-Bribery act, among others. Even if the national anti-corruption regimes of a purchasing country are poorly enforced or ignored by the officials of that country, no responsible U.S. company can tolerate any exposure to liability for improper payments or gratuities to earn a foreign contract or to secure approval of an offset plan. A fundamental element of the offset program of any U.S. company participating in international defense markets must be rigorous, multitiered efforts at supplier and partner diligence and insistence that local partners follow U.S. standards of integrity and compliance. Continuing effort is required to go beyond the assurance made when contracts are awarded, to verify absence of any corrupt activity.

The foregoing discussion, of course, is only an introduction to an area of international commerce that is complex, fraught with both opportunity and risk, but generally little known and too often misunderstood. Foreign markets are growing for U.S. aerospace and defense suppliers. Sales to foreign customers will include offset requirements. Great effort is required to understand the risks and to develop and execute strategies to comply with offset obligations.

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