Trade is a powerful driver for growth in the defense contracting field. International procurement opportunities, however, often come with conditions, called offsets, that introduce significant legal obligations and compliance risks—and also sometimes engender political controversy. Government procurement agencies in more than 100 countries sometimes (or frequently) require offsets when a foreign company wins a contract. And—in this time of diminished defense spending in the United States and Europe—many major defense contractors view navigating offsets as key to their overseas business strategies. Many consultants, advisors, and groups exist to assist companies in addressing offset requirements and risks, but the legal and compliance risks should not be discounted.

The offset phenomenon is not limited to emerging markets or purchasers in the Middle East or Asia. Canada, for instance, recently announced a significant new offset policy in its defense contracting sector, requiring bidders to share advanced technology and intellectual property rights in order to be evaluated favorably for an upcoming $26 billion project for a new Canadian Surface Combatant ship and a $3 billion search-and-rescue aircraft requirement.

Buying countries commonly justify their offset requests based on (1) a policy goal of developing indigenous technology and industrial capacity through sharing of know-how and investment in...
modern facilities, (2) the need to protect their sovereignty in the case of defense contracts; and (3) a desire to reduce imports and improve their balance-of-payments accounts.

This Briefing Paper provides background on offsets and compliance issues companies in the defense industry may face in seeking to fulfill offset obligations. The topic is nuanced and dynamic and may not always be transparent, and offset rules and arrangements vary significantly by country or program. Accordingly, this Briefing Paper should be viewed as a basic guide to key issues, rather than as specific guidance on particular offset requirements or regulations.

What Are Offsets?

There is not a uniform definition of offsets. However, the World Trade Organization (WTO) Agreement on Government Procurement (GPA), which limits, and outside the defense sector prohibits, the use of offsets by its members, defines an offset as “any condition or undertaking that encourages local development or improves a Party’s balance-of-payments accounts, such as the use of domestic content, the licensing of technology, investment, countertrade and similar action or requirement.”

Related terms include compensatory trade agreements, coproduction, barter, and buy backs. The term “offset” is most often used in the aerospace and defense industry, whereas other terms, such as countertrade, may be used in other sectors.

The U.S. Department of Commerce’s Bureau of Industry and Security (BIS) has defined offsets as “the practice by which the award of defense contracts by foreign governments or companies is conditioned upon commitments from the defense contractor to provide some form of compensation to the purchaser. In defense trade, offsets can include activities such as mandatory co-production, credit assistance, licensed production, subcontractor production, technology transfer, purchases, training, and foreign investment.”

More colloquially, offsets are commonly defined as nonstandard contracts that require, as a condition for the sale of goods or services, that the vendor transfer a form of economic activity to the buyer’s government. In short, that means that offsets are side agreements, or sweeteners, ancillary to a government contract that provide additional benefits to the buyer.

Offsets are generally used by purchasing governments to reduce the cost (at least as perceived by their constituents) of procurement from abroad and/or to achieve related or unrelated policy goals, such as advancing the state of domestic industry or broader domestic development goals. Momentum in countering the growth of offsets has stalled since the trend towards liberalizing trade led to the civil offset ban in the WTO GPA in 1994. The 2012 revision to the GPA did not close the loopholes that allowed offsets to continue in the interim. In the global defense marketplace of the last few years, as defense budgets in the United States and Europe have been slashed and producers seek new markets abroad, offsets have played a particularly significant role in the competitive landscape. As a result, at least for the foreseeable future, it appears that offsets are here to stay, and parties engaged in the international defense trade should understand the basics of offsets, as well as the legal and compliance pitfalls that can be associated with them.
Types Of Offsets

■ Direct Offsets

Direct offsets are conditions attached to the prime contract that are directly related to the goods or services being sold in the contract, such as coproduction or local subcontracting. Other activities such as licensed production, training, technology transfers, and financing can be characterized as either direct or indirect offsets, depending on whether they are related to the goods or services being sold under the prime contract. Coproduction, one of the most common forms of direct offset, generally involves the transfer of technology to permit foreign companies to manufacture the product on behalf of the U.S., European, or other seller. Coproduction, as defined by the U.S. Government, always involves a government-to-government agreement. In contrast, licensed production is local manufacturing activity that is not conducted pursuant to a government coproduction agreement.

■ Indirect Offsets

Indirect offsets are conditions associated with a prime contract that are unrelated to the subject matter of the contract. Purchase conditions are always characterized by the U.S. Government as indirect offsets. However, indirect offsets can also take the form of licensed production, investment, training, credit assistance, or technology transfers, among other things. Indirect offsets are the most flexible type since they only require that some form of value be created in the buyer’s country. There are numerous examples of indirect offsets. For instance, U.S. defense companies have sometimes arranged investment in construction, energy, or agriculture in the host country. Because of the complexity of some of these arrangements, a number of offsets consultants, advisors, and brokers exist to assist companies in meeting such obligations.

How Common Are Offsets?

Offsets are associated with many international defense contracts and programs. According to

the annual BIS report on offsets issued in March 2015, in 2013, U.S. defense contractors reported entering into 67 new offset agreements with 18 countries valued at $5.0 billion, which constituted 52.9% of the total value of $9.4 billion in reported foreign defense contracts. Most of the offsets involved technology transfers, subcontracting, or purchases; 34.9% by value were direct offsets and 65.1% were indirect. U.S. firms also reported in 2013 conducting 541 offset transactions with 32 countries to fulfill prior offset obligations, valued at $3.1 billion. From 1993 through 2013, U.S. firms reported entering into 955 contracts containing offsets with 45 countries for defense exports worth $158.4 billion, with a total offset value of $99.8 billion. Some of the largest U.S. defense contractors currently have billions of dollars of outstanding offset obligations—for instance recently Lockheed Martin was publicly reported to have approximately $13 billion in outstanding offset obligations.

Some observers have pointed to private studies showing that these U.S. Government figures may significantly understate the actual number and value of offsets, so those figures should be taken as a minimum. That would not be surprising, given that, in the 2015 report for example, only 17 companies filed required reports to BIS. Throughout the entire 21-year reporting period (1993–2013), only 54 companies responded. It is likely that many more companies have performed contracts abroad that require offsets.

Offsets are a significant part of the defense contracting landscape in a number of countries. For instance, the Gulf Arab states are significant purchasers of U.S. defense articles, both through the Foreign Military Sales (FMS) program and through direct commercial sales. By way of example, Saudi Arabia and the United Arab Emirates—among the largest purchasers of U.S. arms in recent years—have significant and sophisticated offset requirements incident to such purchases. But among major purchasers of U.S. and European defense articles, the Gulf states are not alone. For instance, India, Turkey, and other countries outside the United States and the EU have offset requirements.
What Is The U.S. View Of Offsets?

The U.S. Government is officially opposed to offsets internationally. The Defense Production Act Amendments of 1992 prohibit the U.S. Government from encouraging or committing U.S. defense contractors to enter into offset arrangements for foreign government sales, on the grounds that offsets are “economically inefficient and market distorting.” Nonetheless, recognizing that they have become a core part of competition in the international defense trade, that law seeks to strike a balance between trying to “minimize the adverse effects of offsets in military exports while ensuring that the ability of United States firms to compete for military export sales is not undermined.” To that end, the law might be said to take a see-no-evil-hear-no-evil policy and leaves it to the private sector to work out any offset arrangements without government support or hindrance. Yet, not surprisingly in an area so important to U.S. industry as offsets, the U.S. Government does not take a completely hands-off approach. For instance, the 1994 Feingold Amendment prohibits U.S. contractors from making incentive payments to subcontractors to induce the subcontractors to purchase from abroad in satisfying the prime contractor’s offset obligations.

In addition, the Defense Federal Acquisition Regulation Supplement (DFARS) specifically accommodates offsets imposed by foreign governments or international organizations, allowing contractors to recover costs associated with them under certain conditions in FMS transactions. It provides that all indirect offset costs in FMS contracts are automatically deemed reasonable for the purpose of cost allowability. The U.S. Government does advise companies in the DFARS that it will not help them implement offsets, however.

Moreover, the U.S. Government has an Interagency Working Group on Offsets, led by the Under Secretary of Defense for Acquisition, Technology and Logistics, along with the Departments of Commerce, State, and Labor, and the United States Trade Representative, that is supposed to consult with foreign nations on “limiting the adverse effects of offsets in defense procurement.” But the working group is, again, supposed to balance that goal against a duty to avoid “damaging the economy or the defense industrial base of the United States or United States defense production or defense preparedness.” Given the conflicting goals of this group, it is perhaps not surprising that it has not been able to reduce the widespread use of offsets globally.

What Is The EU’s View Of Offsets?

The EU similarly has a conflicting set of policies on offsets. Offsets, both direct and indirect, are generally prohibited. However, there is an exception for defense and security.

By way of example, a new European Defense Procurement Directive on nondiscrimination and other obligations in contracting excludes certain classified, defense, and security contracts. And in 2009, the European Defence Agency (EDA) issued a Code of Conduct on Offsets, a nonbinding instrument that sets out overarching principles and guidelines for the use of offsets in defense procurement. It acknowledges the presence of offsets in international contracting and tries only to limit and control their use.

But the European Commission’s Directorate General for Internal Markets and Services (DG MARKT) published a strongly worded document stating that offsets “go against the basic principles of the Treaty [on the Functioning of the European Union], because they discriminate against economic operators, goods and services from other Member States and impede the free movement of goods and services. Since they violate basic rules and principles of primary EU law, the Directive [Directive 2009/81/EC on the award of contracts in the fields of defence and security] cannot allow, tolerate or regulate them.” The DG MARKT noted that the Directive did not directly address offsets, “[g]iven the clear legal position under primary EU law.” The Directive prohibits discriminatory contracting conditions, which by implication would include offsets. In addition, the Directive states a policy against offsets when it says that “no performance conditions may pertain to requirements other than those relating to the performance of the contract
itself.” Furthermore, the DG MARKT advised that, despite the exclusion of certain defense and security contracts from the Directive, they are still subject to general principles of EU law, and any offset requirements cannot be so broad as to affect other market participants.

The EU finds offsets to violate basic legal principles because they may prevent companies from purchasing from suppliers in other member states and therefore are considered discriminatory barriers to trade. The DG MARKT said that derogations from Treaty obligations like offsets “must be limited to exceptional and clearly defined cases” and “economic considerations are not accepted as grounds for justifying” their use. The Member State must identify an “essential security interest at stake.” Yet, despite this strong position taken by the Commission, EU companies widely participate in offsets, and a number of EU countries require offsets as part of their defense procurement processes, albeit on an EU rather than a national level.

What Practical Issues Arise In The Context Of Offsets?

■ For Prime Contractors

U.S. prime contractors in the defense sector need to focus time and attention on offsets because they are an important element of the “win strategy” in many deals and because they present substantial compliance risks. This means that they need to (1) know the local offset rules, (2) identify appropriate offsets and offsets partners that will qualify, and (3) ensure that they are not exposing themselves to collateral compliance risks in the course of identifying and fulfilling offset obligations. In addition, as explained above, there are reporting obligations regarding offsets. For instance, on April 4, 2014, BIS published a notice in the Federal Register to remind U.S. firms that they must report annually on foreign defense contracts that are subject to offset agreements exceeding $5 million in value and the performance of offset transactions under existing commitments for which the foreign party claimed offset credit of $250,000 or more.

Understanding the offset rules involves obtaining advice specific to the jurisdiction in which a company is operating. This will often necessitate the involvement of local counsel and/or an advisor, usually working in tandem with internal or external U.S. counsel. In a number of jurisdictions, the offset rules (or their interpretation) are not clear, so tracking offset requirements can be a daunting task. That explains why companies often devote significant time and energy to the process. Nowadays, many major contractors have their own staff devoted to offsets simply to help manage these issues. Identifying offset partners (whether subcontractors for direct offsets or recipients of indirect offsets) is also a challenge. Each of these relationships involves both commercial and compliance risk. Compliance risk frequently relates to anticorruption and export controls as discussed below.

■ For Offset Service Providers

Offset service providers face similar challenges. In particular, apart from being solid commercially, they need to act in a manner that will not present undue risk under anticorruption or export control laws. Good partners will be mindful of these issues and be prepared to respond to vetting or other due diligence inquiries and allow themselves to be subject to reasonable monitoring and auditing. Implementing strong export control and anticorruption policies can go a long way to making prime contractors more comfortable with the offset partners’ bona fides.

Compliance Issues Regarding Offsets

■ Export Controls

Through the International Traffic in Arms Regulations (ITAR), the U.S. Department of State’s Directorate of Defense Trade Controls (DDTC) regulates the temporary import and the permanent and temporary export of defense articles and associated technical data and the provision of defense services. It also regulates defense industry brokering and requires all defense manufacturers, exporters, and brokers to register with DDTC and submit to certain requirements. Companies operating in the ITAR
space must obtain licenses and agreements from DDTC authorizing their activities, unless one of several limited license exemptions applies to a particular activity.52

The items that are controlled by the ITAR are listed on the U.S. Munitions List (USML).53 Traditionally, any items specifically designed or modified for a military application would have been ITAR-controlled.54 Since the rollout of the Administration’s Export Control Reform (ECR) initiative over the past few years, however, the USML has in large areas limited its scope to only those items that are specifically listed.55 Other military items not falling under the ITAR are now regulated by the Commerce Department under the Export Administration Regulations (EAR).56 The ITAR have broad application outside the United States, as the regulations contain no exception for de minimis amounts of U.S.-origin content in foreign defense articles.57 This so-called “see-through” rule means essentially that any military product anywhere in the world with any U.S.-origin content may be ITAR-controlled. Offsets raise numerous potential ITAR compliance concerns. For instance, offsets often require the transfer of technology. While an underlying FMS contract might be subject to various exemptions to ITAR licensing,58 the offset contract may well be subject to significant export controls. Accordingly, there is an inherent tension between the goal of the offset (which is seeking to promote technology transfer) and U.S. export controls (which restrict technology transfers). Therefore, U.S. contractors will need to carefully consider the viability of particular offsets before committing to them and also build in time for seeking and obtaining appropriate export licenses or other authorizations. Moreover, it is conceivable that contractors may face export control issues when working with entities that assist them in the course of identifying offset partners or in working in foreign jurisdictions. Recent changes to brokering rules and registration requirements may ease some of the burdens applicable to foreign persons and entities,59 but even so there could be a need to report fees or commissions paid to such entities under Part 130 of the ITAR.60 In any event, contractors will need to ensure that they have vetted their partners from an export control perspective and that sufficient time is built into any scheduled subcontracts to account for possible delays in receiving licenses, technical assistance agreements, or other authorizations.

### Anticorruption

Offsets have traditionally been viewed as an area of corruption risk.61 For instance, because offsets involve subcontracting or identifying other in-country resources, there has often been a concern that the parties identified might be associated with officials of the foreign government purchaser. There have also been concerns that consultants or advisors who assist with offset fulfillment present typical “third party” anticorruption risks as conduits for bribes that may sway the award of the prime contract or may relate to approvals or other government decisions related to performing the prime contract or fulfilling the offset. Although there are no precise statistics that speak to actual corruption associated with offset fulfillment, Transparency International and others have produced reports and commentary highlighting corruption risks and suggesting potential mechanisms for vetting offset advisors and fulfillment partners.

To understand the anticorruption risks, some background regarding anticorruption law is in order. The Foreign Corrupt Practices Act (FCPA) is the U.S. foreign anticorruption law. It contains both accounting and antibribery provisions. The antibribery provisions impose criminal penalties for making corrupt payments to foreign officials to obtain or retain business.63 The accounting provisions require “issuers,” which include publicly traded companies, including non-U.S. companies with certain listed American depositary receipts, and companies required to file reports with the Securities and Exchange Commission, to keep accurate books and records and to have adequate internal controls, including an anticorruption compliance program.64 The FCPA has very broad jurisdictional reach, and a significant number of enforcement actions have targeted non-U.S. companies, even those with almost no presence in the United States.65 Moreover, the FCPA expressly covers corrupt payments made through third parties, and in effect requires due
diligence, monitoring, and safeguards of any risky third-party arrangements.⁶⁶

In addition to the FCPA, offsets can also implicate local and/or third-country law. This means that a company could be subject to the FCPA, local law, and the UK Bribery Act, for example. The UK Bribery Act is particularly significant because of its potentially broad jurisdictional reach and because it also prohibits commercial bribery and, unlike the FCPA, prohibits facilitating payments.⁶⁷ Accordingly, it is increasingly important for prime contractors to assess “anticorruption” holistically, rather than as simply a U.S. law issue.

One important aspect of managing risk associated with anticorruption law is vetting any third parties as well as entities fulfilling offset obligations. This should be considered for offset consultants and advisors, as well as planned subcontractors or recipients of investment or assistance.⁶⁸ Vetting and due diligence should be risk-based and calibrated to particular circumstances, but typically would involve each party’s filling out a background questionnaire, followed by possible interviews and certifications, as well as implementation of monitoring, auditing, and termination rights in any contracts.⁶⁹ Apart from anticorruption, it should cover adjacent compliance areas such as export controls, as well as commercial risks.

■ Other/Miscellaneous

Offset contracts also involve contractual and commercial risk. In 2013, nearly 87% of the offset agreements that U.S. companies reported to BIS included penalties for nonperformance of the offset obligation, ranging from liquidated damages, increasing the obligation amount or offset requirement, added fees, or posting a performance bond.⁷⁰ But even beyond offset penalties, the complexity of performing many offsets can put at risk the prime contract itself, which is conditioned on performance of the offset. Many countries do not have the infrastructure, skills, or regulatory environment that may be required for effective performance of an offset obligation. It may be challenging, for instance, to identify a competent local partner. That increases the commercial risk involved in the entire venture.

In addition, it can be complex to try to protect certain core intellectual property rights when required to transfer technology and know-how to a foreign company. Moreover, companies need to be thoughtful about how to comply with offsets while not giving away the “crown jewels” and creating serious foreign competitors. Offsets also create financial risks for companies, in determining which aspects, such as performance bonds, need to be provisioned for in accounting statements, and in accurately projecting costs to avoid overruns and possible nonperformance or profit loss. These are just a few highlights of the issues that offsets can present. Companies would be well advised to seek experienced counsel in this area prior to proceeding with an offset contract.

GUIDELINES

These Guidelines are intended to assist you in understanding the compliance issues companies in the defense industry may face in seeking to fulfill offset obligations. They are not, however, a substitute for professional representation in any specific situation.

1. Understand the regulations and policies of the buying country. Does it require direct offsets? Does it require indirect offsets? Where are the offset rules published? How much will offsets affect the award of the prime contract? How are they valued? All of these questions should be considered.

2. Assess challenges associated with offsets. If there is to be technology transfer, will it impact U.S. or foreign export control law? Is there an appropriate local industrial base? How can subcontractors be identified and selected? If there are indirect offsets, who is the appropriate partner?

3. Carefully vet any parties involved in an offset transaction, whether advisors or consultants, or the actual subcontractors that may be involved in the work. Vetting can involve background questionnaires, certifications and representations, and interviews. Build in monitoring and auditing in the course of the work itself.
4. Monitor implementation of offset projects in the same way as the main project. Often neglected by companies, disputes can arise out of offset projects and payment of the last installment of the main contract sometimes depends on the outcome.

5. Develop in-house or external expertise in handling offsets. Train internal staff. Identify experienced outside advisors. Put in place policies and procedures for offsets and regular audits of related activities. Consider joining an offset industry association (e.g. GOCA, ECCO).

REFERENCES

1/ Some of the countries that use offsets include (in alphabetical order): Algeria, Argentina, Australia, Bolivia, Bosnia, Brazil, Brunei, Bulgaria, Canada, Chile, China, Colombia, Costa Rica, Cuba, Ecuador, Egypt, Ethiopia, India, Indonesia, Israel, Japan, Jordan, Kuwait, Macedonia, Malaysia, Mauritius, Mexico, Myanmar/Burma, New Zealand, Nigeria, Oman, Pakistan, Philippines, Qatar, Republic of Korea, Russia, Saudi Arabia, Serbia, Singapore, South Africa, Taiwan, Thailand, Tunisia, Turkey, United Arab Emirates, Uruguay, Venezuela, and Vietnam.


16/ There are several entire industry associations devoted to the offset trade, e.g., the Global Offset and Countertrade Association (GOCA) (http://www.globaloffset.org/) and the European Club for Countertrade and Offset (ECCO) (http://www.ecco-offset.eu/).


27/ Pub.L.No.102-558, § 123(a), 106 Stat 4198 (1992). See also DFARS 225.7306 (“In accordance with the Presidential policy statement of April 16, 1990, DoD does not encourage, enter into, or commit U.S. firms to FMS offset arrangements. The decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved.”).


31/ DFARS 225.7303-2(a)(3).

32/ DFARS 225.7303-2(a)(3).

33/ DFARS 225.7303-2(a)(3).


36/ See Treaty on the Functioning of the European Union art. 346(1)(b), Oct. 26, 2012, 2012 O.J. (C326) 47 (“[A] ny Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the internal market regarding products which are not intended for specifically military purposes.”).


tions/publications/other/defence_offsets (discussing the risks involved in third-party corruption in offset arrangements and the importance of due diligence and safeguards).

50/ See generally 22 C.F.R. pts. 120–130.

51/ 22 C.F.R. pts. 129, 122.

52/ 22 C.F.R. pts. 123, 124, 125, 129.

53/ The USML is at 22 C.F.R. pt. 121.


56/ The EAR are at 15 C.F.R. pts. 730–772. The military items are found primarily in the “600-series” of the Commerce Control List, which can be found here: https://www.bis.doc.gov/index.php/regulations/export-administration-regulations-ear.

57/ In contrast, the EAR do contain a de minimis exception for reexports. See 15 C.F.R. pt. 734.

58/ See, e.g., 22 C.F.R. § 123.4(a)(5) (an ITAR license exemption for temporary imports approved under an FMS program).

59/ See 76 Fed. Reg. 78,578 (Dec. 19, 2011) (amending Part 129 of the ITAR (22 C.F.R. pt. 129) to expand the scope of activities considered “brokering” but also providing additional exemptions to licensing requirements and updating the registration requirements for brokers under the ITAR).

60/ 22 C.F.R. pt. 130.


65/ See 15 U.S.C.A. § 78dd-3 (asserting jurisdiction over “any person…while in the territory of the United States,” which the enforcement agencies interpret very broadly, potentially to include even use of banks, mail, email, etc.).

66/ The FCPA covers payments to “any person, while knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly,” to a foreign official. 15 U.S.C.A. §§ 78dd-1(a)(3), 78dd-2(a)(3), 78dd-3(a)(3).


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