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# Offsets in International Military Procurement

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## PREAMBLE

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Several offset-related developments have occurred since this article was published last year. First of all, new DSAA FMF Guidelines were issued in January 1995. The guidelines make it clear that no FMF "grants" or "Credits" may be used to pay for any direct or indirect offset. However, if the direct commercial contract is financed wholly with repayable FMF "credits" or a combination of FMF "credits" and the foreign buyer's own funds, the "offset administration costs" may be reimbursed.

Second, new FMF guidelines applicable only to Israel were issued by DSAA in January 1995. The use of FMF to pay for any direct or indirect offsets or any related costs of offset administration is also restricted.

Third, the *Security Assistance Management Manual* (SAMM) is scheduled to be revised to render it consistent with changes made in October 1994 to DFARS 225.7303-2.

Finally, the proposed rule requiring the submission of periodic reports on certain company offset activity to the Department of Commerce became a final rule on 2 December 1994 and is retroactive to 1 January 1993. 59 Fed. Reg. 61796 (Dec. 2, 1994). The first report covering Calendar Year 1993 transactions was due 15 March 1995. Since the final rule differs from the proposed rule in a number of significant ways, such as substituting an annual report for a semiannual report, the reader is advised to review the final rule in lieu of relying on the discussion contained in this article.

## INTRODUCTION

Like so many other issues in the international economic arena, the use of "offsets"<sup>1</sup> is a hotly debated matter. The advocates of offsets from less-developed countries argue that offsets allow them to promote economic development and increase their standard of living.<sup>2</sup> Advocates from more-developed countries praise the ability of offsets to enhance, if not create, their country's defense and commercial high-technology infrastructure.<sup>3</sup> The opponents of offsets are typically found in the United States. They cite the negative impact of offsets on employment, technological competitiveness, and the industrial base as key reasons for abolishing offsets.<sup>4</sup>

This article explores the subject of offsets from the perspective of international military procurement and focuses on the basic considerations in negotiating an offset agreement. In addition, the article also addresses current U.S. statutes and regulations relating to offsets as well as recent domestic and international offset initiatives.

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## THE OFFSET AGREEMENT

Foreign buying agencies often regard the execution of a written contract as a mere starting point for the continued refinement of and addition to a contractor's tasks.<sup>5</sup> Thus, a foreign buying agency will often wrap itself within the four corners of the agreement when the contractor seeks specification waivers or schedule relief, but decline to construe the agreement strictly when the agency wants refinements or additions at no cost. Given the obvious risks of allowing the buying agency to have it both ways, the only prudent course of action for contractors is to attempt to structure a clear, detailed agreement and to rely on the "disputes" clause of the contract (or some equivalent) to recover for contract changes if a negotiated settlement cannot be achieved.

### *The Real Parties in Interest to the Offset Agreement*

The Offset Agreement is usually a stand-alone document or annex to the underlying contract. While the buying agency may be the party that executes the Offset Agreement, very often another agency has responsibility for administering the Offset Agreement. For example, in Kuwait the agreement would be with the Ministry of Finance,<sup>6</sup> but in Korea it would be with the Defense Logistics Agency (the buying agency).<sup>7</sup> This issue is particularly important if the contractor and the offset agency (i.e., the non-buying agency that administers the Offset Agreement) disagree over whether the contractor is in compliance with the requirements of the Offset Agreement. Any Offset Agreement should contain mechanisms such as expedited arbitration or mediation for resolving disputes, so that performance of the Offset Agreement does not impact the underlying contract.

Other foreign government agencies, such as the Ministries of Labor, Industry, Trade, or Customs also may play a significant role in the contractor's ability to meet offset targets. For example, a contractor's inability to obtain entry visas, labor permits, or construction clearances could severely inhibit its offset-related plans to establish a local engineering services company. To handle any problems between the contractor and these other agencies, the Offset Agreement should contain clauses requiring the offset agency to resolve these matters and, failing that, providing for resolution of these types of problems by an expedited dispute resolution process.

### *Recognition of Offset Credits*

The date on which offsets will begin to be recognized should be clearly spelled out in the Offset Agreement. It may be the date the Request for Proposal (RFP) is issued, the date the contract is awarded, the effective date of the contract, or the date the Offset Agreement is executed. The contractor may be able to argue in favor of an earlier start date if it initiated an offset program in anticipation of competing for a government procurement.<sup>8</sup>

Many countries have a written (or unwritten rule) that the contractor's offset activity must be motivated by the Offset Agreement.<sup>9</sup> Thus, if the contractor regularly buys disc drives from a local manufacturer, those purchases normally would not be eligible for offset credits. Special care should be taken if the contractor is contemplating the "swap" of credits with third parties (or even with affiliated divisions) or the use of "banked" credits generated from prior local purchases.<sup>10</sup> The contractor needs to understand, in advance of executing the basic contract and the Offset Agreement, what restrictions will apply to the offset credit eligibility determination.

Critical offset terms should be clearly defined in the Offset Agreement to avoid future misunderstandings as to what qualifies for offset recognition. Examples of such terms include "direct offset," "indirect offset," "covered products," "eligible parties," "eligible products," "investment," "high technology," "research and development," "infrastructure," "venture capital," and "educational programs."<sup>11</sup> It also is prudent to include a clause in the Offset Agreement that specifies the time period in which the offset agency has to review offset credit applications.

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Language providing for automatic approval of the offset credits if the offset agency takes too long in evaluating the application would be advantageous as well. The clause also should incorporate an expedited dispute resolution procedure to handle any disagreements.<sup>12</sup>

### *Valuation of the Offset*

The elements of cost that will qualify for value under the Offset Agreement must be understood in advance. The Offset Agreement should provide that the shipping, taxes, and other costs that may be associated with the purchase of the item will be counted toward satisfying the contractor's offset obligations. Assigning a value to technology may also become an issue. Some countries view the value of technology as the development cost to the contractor. Others focus on the current or future commercial value of the technology. The methodology used to value this "know-how" should be stipulated in the Offset Agreement.

In more sophisticated countries, selected areas of offset activity will be eligible for a "multiplier."<sup>13</sup> A multiplier attaches greater weight to specific types of contractor offset activity that are of particular interest to the customer country. Typical activities qualifying for multiplier treatment include technology transfers, infrastructure investment, education/training programs, and performance of activities in economically depressed areas of the customer country.<sup>14</sup> If the customer country fails to provide for multipliers, the contractor should not hesitate to request their use. In addition, if multipliers are used, the contractor may want to consider asking the offset agency to expand the list of items eligible for the multiplier and/or increase the weighted value of the stipulated multipliers.

### *Period of Performance*

Contractors are frequently afforded an amount of time in excess of the basic contract performance period to satisfy their offset obligations.<sup>15</sup> The contractor may, be expected, however, to meet incremental annual offset targets, and achieving the annual targets may be a condition for receiving a milestone payment or for avoiding the assessment of liquidated damages.

The length of the offset completion period has further implications for the contractor if it is required to maintain and pay for a performance bond to cover the performance of its offset obligations. If the contractor is obligated to obtain a single performance bond encompassing both the basic contract and the Offset Agreement, the contractor should ensure that—when the basic contract is completed and only the offset requirements remain—the amount of the performance bond is reduced to the level of any potential offset penalty.

### *Changes to the Contract or Surrounding Circumstances*

After award, the buying agency and contractor may agree to modify the basic contract to add work and thus increase the contract price. The contractor would be well advised to establish a clause in the basic contract stipulating that the contractor's offset obligations shall not be increased in the event of a modification increasing the contract price. Alternatively, the contractor could propose that it will agree to an increase in its offset obligations only if the amount of any single contract modification increases the price beyond a specified dollar threshold, such as \$1 million. Another alternative would be to limit the contractor to a "best efforts" duty to achieve any increased offset obligation.

Most contracts with foreign governments contain an equivalent of the *Changes or Termination for Convenience* clause found in the Federal Acquisition Regulation (FAR).<sup>16</sup> Basic fairness demands that a corresponding reduction in the contractor's offset obligation should follow

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any complete or partial reduction in work under the clause. Otherwise, the contractor will be bearing a proportionately higher offset burden.

Over the course of the Offset Agreement's performance, unexpected situations may arise that impede the accomplishment of offset requirements. For example, a local supplier specified in the plan for direct offset purchases may go out of business or the United States may rescind a previously approved technology transfer. In anticipation of such contingencies, the contractor should attempt to include a provision in the Offset Agreement allowing for the substitution of suppliers, services, technology, and indirect for direct offsets.

### ***Contractor's Liability for Failure to Achieve Offset Requirements***

The consequences of a contractor failing to meet its offset obligations are determined in large part by whether the Offset Agreement characterizes the obligations as "best efforts" or "mandatory."

If "best efforts" are required, the contractor only has a duty of good faith in attempting to satisfy the offset terms. Consequently, the duty is closer to a "moral" obligation rather than a "legal" one.<sup>17</sup> Given this looser standard, a contractor should take advantage of "best efforts" obligations whenever possible, but remain sensitive to the possibility that failure to achieve offset goals may affect the contractor's eligibility for future business.

If the offset obligations are "mandatory" (or "binding"), the contractor may be subjected to a default termination or damages for breach of contract if the offset requirements are not fulfilled. Frequently, however, the Offset Agreement will contain a liquidated damages clause.<sup>18</sup> As with any liquidated damages clause, the contractor should attempt to negotiate a grace period before liquidated damages are imposed as well as a ceiling on the contractor's total liability for such damages.

Ironically, if the Offset Agreement lacks a liquidated damages clause, it may be in the contractor's best interest to request that such a clause be added. With a liquidated damages clause, the contractor is in a position to calculate the cost of the risk and price it into the contract. Absent a liquidated damages clause, the contractor's risk is that the failure to achieve the offset target is a material breach of contract, in which case the entire contract may be terminated for default.

It should be noted that if a contractor relies on the imposition of liquidated damages as a mere cost of doing business and consequently devotes little time and effort to performing the Offset Agreement, it may find itself ineligible for future contracts. Offset Agreements often represent not only contractual duties but also the implementation of politically sensitive public policy objectives of the foreign country. A contractor with a cavalier attitude toward fulfilling offset requirements will probably be perceived as possessing little integrity and such a negative image could inhibit severely the contractor's ability to compete for business in the international marketplace.

### **OFFSETS IN INTERNATIONAL MILITARY SALES**

The three common types of international military sales that may involve offsets are: (1) Foreign Military Sales (FMS); (2) Foreign Military Financed (FMF) direct commercial sales; and (3) "pure" direct commercial sales.<sup>19</sup> The policy of the Department of Defense (DoD) is generally to look with passive disfavor upon offsets.<sup>20</sup> On the other hand, DoD recognizes that offsets have become a fundamental requirement of many foreign procurements. The tension between the general DoD policy and the agency's recognition of the real-world significance of offsets varies with the three types of international military sales.

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## *FMS*

As a general rule, FMS are negotiated and administered like any other DoD procurement.<sup>21</sup> One of the exceptions to this rule, however, involves the treatment of offsets. Although "it is DoD policy not to enter into government-to-government offset arrangements because of the inherent difficulties in negotiating and implementing such arrangements,"<sup>22</sup> DoD will not prohibit a contractor from negotiating its own Offset Agreement with a foreign government.<sup>23</sup> DoD also allows the contractor to recover certain "offset administrative costs" associated with implementing the Offset Agreement as a cost of contract performance.<sup>24</sup> Offset administrative costs include, for example, the cost of in-house organizations to implement the offset, the cost of overseas offices and foreign consultants, and the cost of employee travel.<sup>25</sup>

Even if the cost is a clear example of an offset administrative cost, it still may not be recognized as an allowable cost for U. S. Government contract purposes unless the following current requirements set forth in the Security Assistance Management Manual (SAMM) are met:

1. The costs are included within the applicable line item cost within the FMS Letter of Offer and Acceptance (LOA);
2. The costs are included under LOAs wholly financed with cash or repayable FMF Credits;
3. The costs are provided by the contractor, normally through the Contracting Officer for inclusion in the LOA. Any manufacturer of an item for which the buying agency has requested an offset may quote offset administrative costs for inclusion in the LOA. The costs will not be added following countersignature of the LOA [Editor's note. A DSAA interim change (dated 21 October 1994) to the SAMM, Section 140107 B (4) allows these costs to be added to an LOA after acceptance (through an LOA modification).]; and.
4. A note must be added to the LOA when these costs are included.<sup>26</sup> [Editor's note. This LOA note is now included as a supplemental condition to all LOAs: it will be included in future LOAs as part of the boilerplate standard terms and conditions.]

These conditions may be summarized in three words: notice, timing, and allocability. The estimated offset administrative costs should be disclosed by the contractor to DoD as a cost of FMS contract performance. The disclosure of the contractor's, as well as its subcontractors', estimated "offset administrative costs" must, in turn, be disclosed by DoD to the foreign government buyer in DoD's LOA.<sup>27</sup> Therefore, the contractor should include an estimate of these costs in its Planning and Review (P&R) Data and/or Pricing and Availability (P&A) Data. but, in any event, the contractor should ensure that DoD notes these costs in the LOA that is submitted to the foreign government for countersignature.<sup>28</sup>

## *FMF Direct Commercial Sales*

The SAMM spells out DoD policy as they relate to FMF sales: "FMF is discouraged for purchases containing offset provisions as a condition for securing the purchase."<sup>29</sup> The SAMM continues as follows:

- A. No FMF will be authorized or disbursed to pay for offsets, to include mandatory direct offsets, or the related costs of offset management. Mandatory direct offsets are procurements of a non-U.S. made component required by the purchasing country as a condition of sale, for incorporation or installation in a U.S. produced end item being sold.

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B. While FMF will not be authorized for foreign produced content resulting from mandatory direct offset, such funding can be authorized for the U.S. content portion of the item produced.<sup>30</sup>

As a general rule, then, FMF may not be used for the contractor's purchases from suppliers in the foreign country.<sup>31</sup> It is not entirely clear, however, whether the SAMM's prohibition on financing the related costs of offset management also represents a prohibition on financing offset administrative costs. The presumption should be that if "offset administrative costs" are allowable for FMS government-to-government sales, they should be allowable for FMF direct commercial sales, particularly if the FMF credits are repayable by the foreign government. A contractor facing this issue should request formal clarification from the Defense Security Assistance Agency to avoid confusion and inconsistencies in the treatment of offset administrative costs.

### *"Pure" Direct Commercial Sales*

On direct commercial sales that do not involve U.S. Government financing, contractors commonly believe that most, if not all, of the U.S. Government's statutory and regulatory regime can be avoided. While this perception is largely true with regard to application of the FAR, the DoD FAR Supplement (DFARS), and SAMM, it unfortunately is not true with respect to a host of other statutes and regulations. For example, any offset involving the transfer of technology governed by the Arms Export Control Act of 1976<sup>32</sup> would require the contractor to obtain an export license in accordance with the International Traffic In Arms Regulation (ITAR).<sup>33</sup> The import into the U.S. of components or other items from suppliers located in the customer's country raises the specter of the U.S. antidumping,<sup>34</sup> countervailing duty,<sup>35</sup> and antitrust<sup>36</sup> laws. Finally, to the extent such financing is available, the U.S. Export-Import Bank places limits on whether loan guarantees may cover the acquisition of foreign components under an offset program.<sup>37</sup>

## RECENT STATUTORY AND REGULATORY INITIATIVES RELATING TO OFFSETS

### *The Feingold Amendment*

The use of offsets by foreign governments has been the subject of U.S. congressional and executive inquiry for a number of years.<sup>38</sup> The most recent legislative initiative on offsets is an amendment initiated by Sen. Russell Feingold (D., Wis.) to the Arms Export Control Act.<sup>39</sup>

Sen. Feingold introduced the amendment in response to the concern of Harnischfeger Industries, Inc. over a \$1 million-plus offer made by Northrop Corporation to one of Harnischfeger's customers as an incentive for that customer to buy paper-making machinery from Valmet Corporation, a Finnish company. Northrop offered the incentive payment in order to help meet its offset obligations under a \$3 billion sale of F/A-18 Hornet jet fighters to Finland. Harnischfeger nevertheless won the related competition against Valmet, but indicated it would experience a loss in performing the contract.<sup>40</sup> The Departments of Defense and Commerce investigated the matter and concluded that no law was broken. Although Finland and the U.S. have entered into a defense Memorandum of Understanding (MOU), the agreement only discourages offsets; it does not prohibit them.<sup>41</sup>

Sen. Feingold's amendment<sup>42</sup> found its way into the Foreign Relations Authorization Act, Fiscal Year 1994 and 1995,<sup>43</sup> which the President signed on April 30, 1994. Section 732<sup>44</sup> of the law requires the President, on certain-value high dollar foreign weapon sales, to certify to Congress whether an Offset Agreement will form part of the FMS government-to-government or direct (FMF or "pure") commercial sale. Section 733<sup>45</sup> prohibits U.S. contractors from making incentive payments to a U.S. company or individual where the purpose of such payment is to induce or persuade them to buy goods or services from a foreign country that has an Offset Agreement with

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the contractor. Violations of the law are punishable by civil fines (not to exceed \$500,000 or five times the amount of the incentive payment), administrative sanctions, and possible criminal penalties.<sup>46</sup>

### *New Rules on Contractor Offset Reporting and Offset Administrative Costs*

The latest regulatory initiatives on offsets were published in the *Federal Register* in April and October 1994.<sup>47</sup> Pursuant to the Defense Production Act Amendments of 1992,<sup>48</sup> a proposed rule was issued in April 1994 that would require contractors involved in the sale of weapon systems or defense-related items to foreign customers to submit a semiannual report to the Department of Commerce if the contractor is subject to an Offset Agreement in excess of \$5 million in value.<sup>49</sup> An October 1994 revision to the DFARS rule governing the recovery of "offset administrative costs" restricts the allowability of such costs to those LOAs<sup>50</sup> financed wholly with the cash of a foreign government customer or repayable FMF credits. This revision renders the DFARS more consistent with the SAMM.<sup>51</sup>

### *North American Free Trade Agreement (NAFTA)*<sup>52</sup>

As a general rule, NAFTA prohibits the U.S., Mexico, and Canada from imposing offset requirements on government procurements.<sup>53</sup> On the surface, NAFTA should be considered a major victory for the U.S. government, long an opponent of offsets. Unfortunately, the scope of this ban on offsets is severely limited, particularly in the case of military procurements.<sup>54</sup>

The NAFTA negotiators carved out significant exceptions for defense procurements. For example, NAFTA does not apply to the "procurement of arms, ammunition, or war materials, or to procurement indispensable for national security or for national defense purposes . . . [or] necessary to protect public morals, order or safety. . . ."<sup>55</sup> Moreover, the respective countries' defense agencies are barred from discriminating against the products of the other two signatories only if the product is specifically listed as an eligible product in an Annex of NAFTA.<sup>56</sup> Most of the products in the Annex are nonmilitary in nature.

With respect to services, NAFTA takes a different approach. Instead of a list of eligible services, another NAFTA Annex provides a long list of those specific services that are not subject to NAFTA, such as "research and development services."<sup>57</sup> Construction services are subject to a two-tiered test. First, the service must be listed as a covered construction service under NAFTA.<sup>58</sup> Second, the service must not be otherwise excluded from NAFTA coverage.<sup>59</sup>

Finally, several special exceptions apply just to Mexico. One NAFTA Annex allows Mexico to impose a certain percentage of local content requirement (i.e., offsets) for either (1) labor intensive turnkey or major integrated projects or (2) capital intensive turnkey or major integrated projects.<sup>60</sup> That same Annex permits Mexico to set aside up to \$1 billion in government procurements from the coverage of NAFTA. Still another NAFTA Annex recognizes that Mexico has not completed its lists of excluded services.<sup>61</sup> Until Mexico finishes the list, which it must do not later than July 1, 1995, a Temporary Schedule of Services subject to NAFTA will be in operation. Few items on the Temporary Schedule would be of interest to U.S. defense contractors.

The U.S. Government has taken prompt steps to implement the provisions of NAFTA into the federal procurement system.<sup>62</sup> Canada is also expected to promptly comply. Mexico is beginning the process to create the necessary institutions and framework for compliance. Nevertheless, with all of the exceptions for defense-related procurements, NAFTA offers little in the way of significant new opportunities for defense contractors. As far as offsets are concerned, they will remain a factor for U.S. defense contractors seeking to do business in Canada or Mexico.

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## *General Agreement on Tariffs and Trade (GATT)*<sup>63</sup>

In the past, GATT officials have taken the position that offsets on government procurements were not "per se" violations of GATT.<sup>64</sup> Furthermore, the 1979 GATT Tokyo Round<sup>65</sup> government procurement agreement contained broad national security exceptions,<sup>66</sup> which eliminated any argument that procurements of weapons and related systems were subject to GATT.

Thus, governments were free to discriminate (i.e., impose offset requirements) in most defense procurements.

In parallel with the GATT Uruguay Round,<sup>67</sup> the GATT Working Group on Negotiations in Government Procurement completed negotiation of the new "Agreement on Government Procurement."<sup>68</sup> This new GATT government procurement code represents a marked improvement over earlier codes, particularly since it prohibits, as a general rule, any member country from imposing offsets on foreign contractors as a condition of award.<sup>69</sup> The national security exception remains, however, and it operates to emasculate the general rule insofar as military procurements are concerned.<sup>70</sup> Therefore, contractors will continue to see offsets imposed on the sale to foreign governments of weapon systems and related items.

## CONCLUSION

Although the United States has made progress in breaking down the barriers created by foreign government offset programs, the "national security" exceptions of NAFTA and GATT will permit foreign governments to continue the imposition of offset requirements on their military procurements. American contractors have no choice, then, but to accept the general concept of offsets as a foreign customer requirement. As a consequence, contractors would wise to adopt a positive attitude toward offsets and view them as a marketing tool rather than a selling obstacle.

At the same time, the U.S. Government should focus its attention on international diplomatic initiatives to eliminate offsets instead of on measures to punish contractors that are subject to offset requirements. Putting U.S. contractors in the middle of the offset controversy will only enhance the competitive position of foreign competitors. To their credit, some U.S. Government organizations have indicated a willingness to recognize the difficult position of U.S. contractors when it comes to offsets, even going so far as to "sponsor" joint ventures in foreign countries to help U.S. contractors meet offset goals.<sup>71</sup>

## ENDNOTES

<sup>1</sup>The term "offset" has been subjected to many definitions. One commentator defined it as "[a] generic term meaning any benefit received by the purchasing country (direct, indirect, industrial, economic, or otherwise) required as part of a defense transaction." Marvel, *The Evolving World of International Offset Contracting*, Mil. Tech., Oct. 1989, at 42, 43. One of the most detailed definitions of "offset" can be found in a December 1990 report entitled *Negotiations Concerning Offsets in Military Exports* sent by the Office of Management and Budget to Congress: *Offsets* are a range of industrial and commercial compensation practices required as a condition of purchase in either government-to-government or commercial sales of defense articles and/or defense services as defined by the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations (ITAR). The various means to implement offsets are:

*Coproduction.* Overseas production based upon government-to-government agreement that permits a foreign government(s) or producer(s) to acquire the technical information to manufacture all or part of a U.S. origin defense article. It includes government-to-government licensed production. It excludes licensed production based upon direct commercial arrangements by U.S. manufacturers. *Licensed production.* Overseas production of a U.S. origin defense article based upon transfer of technical information under direct commercial arrangements between a U.S. manufacturer and a foreign government or producer. *Subcontractor production.* Overseas production of a part or component of a U.S. origin defense article. The subcontract does not necessarily

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involve license of technical information and is usually a direct commercial arrangement between the U.S. manufacturer and a foreign producer. *Overseas investment*. Investment arising from the offset agreement, taking the form of capital invested to establish or expand a subsidiary or joint venture in the foreign country. *Technology transfer*. Transfer of technology that occurs as a result of an offset agreement and that may take the form of research and development conducted abroad, technical assistance provided to the subsidiary or joint venture of overseas investment, or other activities under direct commercial arrangement between the U.S. manufacturer and a foreign entity. *Countertrade*. In addition to the types of offsets defined above, various types of commercial countertrade arrangements may be required. A contract may include one or more of the following mechanisms: *Barter*. A one-time transaction only, bound under a single contract that specifies the exchange of selected goods or services for another of equivalent value. *Counter-purchase*. An agreement by the initial exporter to buy (or to find a buyer for) a specific value of goods (often stated as a percentage of the value of the original export) from the original importer during a specified time period. *Compensation* (or buy-back). An agreement by the original exporter to accept as full or partial repayment products derived from the original exported product. Within the business community, offsets associated with military exports are frequently divided into direct and indirect classes. *Direct offsets*. Contractual arrangements that involve goods and services referenced in the sales agreement for military exports. *Indirect offsets*. Contractual arrangements that involve goods and services unrelated to the exports referenced in the sales agreement. *Id.*; see also, Gen. Acct. Off., Rept. No. GAO/NSIAD-94-127, *Military Exports: Concerns Over Offsets Generated with U.S. Foreign Military Financing Program Funds*, 18-19 (June 22, 1994).

<sup>2</sup>Alexandrides, *Countertrade & Global Strategies*, Cont. Mgmt., Sep. 1990, at 5,10. See also Ashraf, *Saudis Use Arms Deals to Build Their Economy*, Reuter Library Report, July 25, 1993; Pura, *Malaysia to Buy Military Planes from Russia*, Wall St. J. (West. Ed.), June 28, 1994, at A11.

<sup>3</sup>Canada, for example, has used its military shipbuilding and aircraft programs to establish its defense infrastructure. Marvel, *supra* note 1, at 43. As a result of its offset program with General Dynamics, Turkey is capable of manufacturing F-16 aircraft. *Id.*; *Military Exports*, *supra* note 1, at 7.

<sup>4</sup>See, e.g., *Military Exports*, *supra* note 1; Gen. Acct. Off., Rept. No. GAO/T-NSIAD-94-215, *Military Sales: Concerns Over Offsets Generated Using U.S. Foreign Military Financing Program Funds*, (June 22, 1994); GAO, *Lawmakers Criticize Offsets under Foreign Military Financing Program*, Daily Report for Executives (BNA)(June 23, 1994); 1989 Defense Authorization Act, Pub. L. No. 456, §825(a), 102 Stat. 1918, 2019; 1992 Defense Production Act Amendments, Pub. L. No. 102-558, § 123, 106 Stat. 4198, 4206. See also note 38 *infra*.

<sup>5</sup>Marvel, *International Offset Contracts*, a paper presented to the First Annual NCMA International Business Acquisition Conference, Sept. 1993, at 4.

<sup>6</sup>State of Kuwait, Ministry of Finance, *Countertrade Offset Programme*, A-1; see also Ernst & Young, *Doing Business in Kuwait*, 1993, at 9.

<sup>7</sup>Defense Logistics Agency, Ministry of Defense, Republic of Korea, *Korean Defense Offset Program Guidelines*, Jan. 1992, at 37.

<sup>8</sup>Marvel, *supra* note 5, at 6.

<sup>9</sup>*Id.*

<sup>10</sup>*Id.* at 8. "Swapping" involves "the trading of credits between contractors." *Id.* In fact, a specialized industry has evolved to facilitate the exchange of credits. Some countries may also permit contractors to "bank" credits. *Id.* "Banking" means the contractor may accumulate and store credits for utilization on subsequent offset programs. *Id.* See also, e.g., *Korean Defense Offset Program Guidelines*, *supra* note 7, at 5, 42. Another related issue is obtaining pre-approval of certain offset credit programs, particularly in the case of technology transfers or joint venture creation. The cost of these types of offset activities is high and once the technology is transferred or the joint venture is established, the contractor's leverage in negotiating full offset credit recognition is low. Marvel, *supra* note 5, at 9.

<sup>11</sup>Marvel, *supra* note 5, at 9.

<sup>12</sup>*Id.* at 11.

<sup>13</sup>*Id.* at 7. Korea describes the multiplier as "weighted values." *Korean Defense Offset Program Guidelines*, *supra* note 7, at 24-27. The Kuwaiti Government employs the term "incentives." *Countertrade Offset Programme*, *supra* note 6, at 6-8.

<sup>14</sup>*Id.*

<sup>15</sup>In Kuwait, the offset completion period is normally eight years. *Countertrade Offset Programme*, *supra* note 6, at 10. By way of contrast, Korea normally requires the offset completion period to correspond to the performance period of the basic contract. *Korean Defense Offset Program Guidelines*, *supra* note 7, at 18.

<sup>16</sup>See, e.g., FAR 52.243-1 and FAR 52.249-2.

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<sup>17</sup>Marvel. *supra* note 1, at 44.

<sup>18</sup>Under U.C.C. § 2-718(1): Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty. The U.S. Government procurement practice on liquidated damages is consistent with U.C.C. 2-718(1), *viz.*, the amount of liquidated damages must be reasonable, such as to not constitute a penalty. FAR 12.202. Foreign governments, however, are rarely restricted to a reasonableness standard in establishing a liquidated damages rate. In fact, foreign governments frequently discuss liquidated damages in terms of a penalty.

<sup>19</sup>The sale of defense articles and services is regulated by the Arms Export Control Act (AECA) of 1976. 22 U.S.C. §§2751-94 (1992). Although the State Department has overall responsibility for the general direction of military export sales, the Department of Defense (DoD) is the primary agency for implementing the Foreign Military Sales (FMS) Program. Within DoD, the Defense Security Assistance Agency (DSAA) has primary responsibility for managing the program. The detailed policies and procedures governing the FMS Program are contained in DoD 5105.38-M, the Security Assistance Management Manual (SAMM). There are two basic types of FMS transactions.

The first type is a government-to-government sale in which the U.S. Government through DoD contracts directly with a foreign government. Government-to-government sales take two forms: FMS stock sales and FMS procurement sales. 22 U.S.C. §§ 2761-62 (1992). Only FMS procurement sales will be discussed here. FMS procurement sales involve DoD's purchase of items from contractors for resale to the foreign government. Such sales are covered by the SAMM, as well as the FAR and DFARS. DFARS 225.7301(b); Department of Defense, *DoD 5105.38-M, Security Assistance Mgmt. Manual* 20202.B.1 & 80101.A & B (hereinafter *SAMM*); *see generally* Reuter, *The ABCs of FMS*, Cont. Mgmt., Oct. 1990, at 29. The other basic type of FMS transaction is the direct commercial sale. These sales involve the U.S. contractor negotiating directly with the foreign government customer. Such sales typically will be made with U.S. Government financing (i.e., FMS credit), administered by DSAA, and governed by the FMS rules contained in the SAMM, but not by the FAR and DFARS. 22 U.S.C. §§ 2763, 2771, & 2774 (1992). On the other hand, if the sale is made without U.S. Government financing (i.e., a "pure" direct commercial sale), it will not come within the purview of the FMS program and accordingly, will not be subject to either the SAMM or the FAR or DFARS; but it will be covered by the export licensing regime of the International Traffic in Arms Regulation (ITAR). 22 C.F.R. Parts 120-130. In U. S. Government Fiscal Year 1988, the FMS Credit Program began to evolve primarily into a "repayment forgiven" loan program. The funds appropriated by Congress thus took on the characteristics of a grant program. These funds could be used by the countries designated by Congress to purchase military items through either FMS government-to-government procurement sale or direct commercial sale channels. The program is now generally known as the Foreign Military Financing (FMF) program. The General Accounting Office described the FMF program as follows: Foreign Military Financing is largely a grant aid military assistance program that enables U.S. allies to improve their defense capabilities through the acquisition of U.S. military goods and services. The Department of Defense's (DoD) Defense Security Assistance Agency is responsible for managing the Foreign Military Financing program by approving contracts and payments. Israel and Egypt are the largest program recipients, with annual grants of \$1.8 billion and \$1.3 billion, respectively. Most countries receiving Foreign Military Financing generally purchase goods and services through government-to-government contracts, also known as Foreign Military Sales. Under this procurement channel, the U.S. government buys the desired item on behalf of the foreign country, generally employing the same criteria as if the item were being procured for the U.S. military. Selected countries, including Israel and Egypt, could also apply their Foreign Military Financing funds to direct commercial contracts. Under direct commercial contracts, the foreign government selects the source and manages the contract. The U.S. government is not a party to such contracts. Gen. Acct. Off., Rept. No. GAO/NSIA-93-184, *Military Sales to Egypt and Israel*, July 1993, at 2. *See also* GAO *Urges Tighter Controls on Commercial Sales Under Foreign Military Financing Program*, 60 Fed. Cont. Rep. (BNA) 143 (Aug. 16, 1993). On June 3, 1993, the DSAA issued a letter announcing that effective January 1, 1994, the use of FMF will be available only for government-to-government procurement sales and not direct commercial sales. *Id.* DSAA took this action in response to Congressional criticism of the lack of oversight and a DoD Inspector General audit that discovered program weaknesses. The effective date was then extended to July 1, 1994, in response to Congressional concerns that all affected parties be consulted. 60 Fed. Cont. Rep. (BNA) 633 (Dec. 20, 1993); *See* Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1994, Pub. L. No. 103-87, §572, 107 Stat. 931, 971 (1993); Green & McGrath, *U.S. Foreign Military Assistance: Audits, Investigations & the Significance of the Possible Elimination of Federally-Funded Direct Commercial Contracts*, 6 Int'l Proc. Rep. (BNA) 1, 2 (Jan. 1994). In mid-July 1994, DoD announced that the consultations were completed and would

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continue to allow FMF to be used for direct commercial contracts on an exception basis. 59 Fed. Reg. 36743 (July 19, 1994). The countries that currently are currently eligible for the FMF program include Egypt, Greece, Israel, and Turkey. *SAMM* Table 902-5A, Paragraph 6.

<sup>20</sup>DFARS 225.7307-1(c) states: The Presidential policy statement of April 16, 1990, provides that DoD shall not encourage, enter directly into, or commit U.S. firms, to any FMS/offset arrangement. The decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved. Exceptions to this policy must be approved by the President through the National Security Council. *See also Military Exports, supra* note 1, at 2, 9, 12. *U.S. Still Against Playing Active Role in Barter, Countertrade, Officials Say*, 8 Int'l Trade Rep. (BNA) 1644 (Nov. 13, 1991). Even in negotiating reciprocal Memoranda of Understanding (MOU) waiving the Buy American Act to certain foreign governments, DoD usually limits the language on offsets to words of discouragement, rather than of significant restriction. *DoD, Commerce Find Northrop Broke No Laws in Undercutting U.S. Firm to Further Offset*, 10 Int'l Trade Rep. (BNA) 865 (May 26, 1993). *See also* DFARS 225.872-1; *Military Exports, supra* note 1, at 20-21.

<sup>21</sup>FMS procurement sales are "conducted under the same acquisition and contract management procedures as other defense acquisitions." DFARS 225.7301(b). *See also* DFARS 225.7303-2(b); *SAMM* 20202.B.1 & 80101.A & B. Thus, foreign suppliers that represent part of the contractor's direct offset program would be subject to the FAR and DFARS, including the requirements to provide certified cost or pricing data and access to records. *See* FAR Subpart 15.8; FAR 52.215-1; FAR 52.215-2. *See also Military Exports, supra* note 1, at 20-21.

<sup>22</sup>*SAMM* 140107.A. One commentator described the background behind this DoD policy as follows: Since the 4 May 1978 memorandum from then US Deputy Secretary of Defense Charles Duncan (The Duncan Memo), the US Government has maintained a 'hands-off' policy concerning offsets, requiring them to be contracted for and implemented under separate agreement with the defence manufacturer. This policy, which stood inviolate for over 12 years until this August, 1989, arose after the US had undertaken a government-to-government commitment to furnish high technology offsets and implementation was frustrated by a defaulting private contractor. As stated, the policy sought to place a 'wall' of non-involvement between the US and the private contractor's offset commitment(s) . . . *Marvel, supra* note 1, at 42-43.

<sup>23</sup>Any DoD Letter of Offer and Acceptance (LOA) containing contractor offset administrative costs should state: DoD policy authorizes administrative costs associated with the implementation of offset agreements between the US contractor and foreign customer to be included in the price of the items offered in this LOA. The price of FMS contracts awarded in support of this LOA may include administrative costs associated with implementation of the customer's offset requirement from US industry. DoD is not a party to such offset arrangements and assumes no obligation to satisfy the offset requirement or to bear any of the associated costs. *SAMM* 70105.L.4. *See also* DFARS 225.7303-2(a)(2)(iii)(A); *No Change Seen in Bush Administration's Offset Policy for Foreign Military Sales*, 17 Int'l Trade Rep. (BNA) 580 (Aug. 25, 1990).

<sup>24</sup>DFARS 225.7303-2. *See also* DFARS 225.7307. The catalyst for recognizing the allowability of offset administrative costs was a recommendation from the Defense Policy Advisory Committee on Trade (DPACT). 56 Fed. Reg. 34030 (July 25, 1991). *See also* Director of Defense Procurement Eleanor R. Spector Memorandum, *Offset Administrative Costs* (July 15, 1991) (hereinafter *Spector Memorandum*). The DoD position on the allowability of offset administrative costs is that unlike "foreign selling costs, they generally are unallowable overhead costs." 56 Fed. Reg. 34030 (July 25, 1991); 56 Fed. Reg. 60066 (Nov. 27, 1991); *DoD, Commerce Find Northrop Broke No Laws in Undercutting U.S. Firm to Further Offset, supra* note 20. The DCAA view is that "[a]uditors should be sure that these additional costs are not charged to indirect expense pools and allocated to domestic business. . . Costs incurred as a result of offset agreements are therefore not allocable to domestic government contracts and should be questioned if claimed by the contractor." Defense Cont. Audit Agency, Cont. Audit Manual ¶ 7-1307.4 (July 1994); *Military Exports, supra* note 1, at 7-8, 21. Notwithstanding the allowability of offset administrative costs, the contractor should be sensitive to the foreign customer's reaction to these costs since they are, in effect, being charged to implement their national policy.

<sup>25</sup>DFARS 225.7303-2(a)(3)(iii) states: Some examples of offset administrative costs are - (A) In-house and/or purchased: organizational, administrative and technical support, including offset staffing; quality assurance, manufacturing, purchasing support; data acquisition; proposal, transaction and report preparation; broker/trading services; legal support; and similar support activities; (B) Off-shore operations for technical representative and consultant activities, office operations, customer and industry interface, capability surveys; (C) Marketing assistance and related technical assistance, transfer of technical information and related training; (D) Employee travel and subsistence costs; and (E) Taxes and duties. In April 1994, DoD proposed a change to DFARS 225.7303-2(a). 59 Fed. Reg. 17756 (proposed Apr. 14, 1994). *See also* 59 Fed. Reg. 19753 (proposed Apr. 25,

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1994). The proposed changes became a final rule, effective September 28, 1994. 59 Fed. Reg. 50511 (Oct. 4, 1994). The changes amend subparagraph (a) of DFARS 225.7303-2 to allow the contractor to recover offset administrative costs only if "the foreign military sale Letter of Offer and Acceptance is financed wholly with customer cash or repayable foreign military finance credits." This change renders the DFARS consistent with the current language found in SAMM 140107.B.2. The change also eliminates the language in the DFARS that required "notes" explaining DoD's position on offsets and discussed the timing aspects of proposing offset administrative costs. See note 26 *infra*.

<sup>26</sup>SAMM 140107.B. See also *Military Exports*, *supra* note 1, at 21. DoD has introduced a minor degree of confusion by its reference to the term "industry administrative costs" in the discussion of "offset administrative costs" at SAMM 104107.B. However, the context of the paragraph suggests that "industry administrative costs" is synonymous with "offset administrative costs." Support for this position can be found in SAMM 70105.L.4. which uses the term "industry offset administrative costs." Prior to the October 4, 1994, revision of DFARS 225.7303-2, the language at paragraph (a)(2)(iii)(A) provided: (A) A U.S. defense contractor may recover, under an FMS contract, costs incurred to implement specific requirements of its offset agreement with a foreign government or international organization if the foreign military sale Letter of Offer and Acceptance (LOA) contains a note that - (1) Specifically addresses offsets; (2) Advises foreign governments that the price of contracts awarded in support of the LOA may include administrative costs associated with implementing the foreign purchaser's offset agreement with the contractor; and (3) Includes a statement that the U.S. Government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs. The new DFARS rule deletes the old language requiring "notes" and replaces it with the following: (i) A U.S. defense contractor may recover costs incurred to administer specific requirements of its offset agreement with a foreign government or international organization if the foreign military sale Letter of Offer and Acceptance is financed wholly with customer case or repayable foreign military finance credits. (ii) The U.S. Government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs. DFARS 225.7303-2(a)(3)(i)-(ii), 59 Fed. Reg. 50511, 50512 (Oct. 4, 1994). The explanatory information on the *Federal Register* suggests that the corresponding note requirement found in SAMM 140107.B will be deleted in the future. *Id.* at 50511. The current language of SAMM 140107.B.3 indicates that the contractor may have until the time of the foreign government's countersignature on the LOA to propose offset administrative costs. The old DFARS 225.7303-2(a)(2)(iii)(B) language required the contractor to propose these costs at an earlier date: "Estimated offset administrative costs must be included in foreign military sales pricing information provided to the foreign government as early as possible, but before submittal of the LOA." *Id.* The proposed elimination of this DFARS language in the new final rule may mean that both time bars have been removed.

<sup>27</sup>DD Form 1513. See SAMM Table 701-1.

<sup>28</sup>Spector Memorandum, *supra* note 24. See also *supra* note 26.

<sup>29</sup>SAMM, Table 902-5A, ¶ 4. See also *Military Sales*, *supra* note 4; GAO, *Lawmakers Criticize Offsets under Foreign Military Financing Program*, *supra* note 4.

<sup>30</sup>SAMM Table 902-5A; ¶ 4.

<sup>31</sup>Although non-U.S. components are generally ineligible for FMF, an exception does exist for non-U.S. components that are an integral part of the end product and that DoD itself purchases the item from the same non-U.S. source. SAMM, Table 902-5A, ¶ 2. Additional special exceptions have also been granted for Israel and Egypt. See 22 U.S.C. § 2791(c) (1992); SAMM, 90210.A; *Military Exports*, *supra* note 1, at 4, 18-19.

<sup>32</sup>Pub. L. No. 94-329, 90 Stat. 734 (1976) (codified at 22 U.S.C. §§ 2751-94 (1992)). See notes 44 & 45 *infra*. See also Export Administration Act of 1979, Pub. L. No. 96-72, 93 Stat. 503 (1979) (codified at 50 U.S.C. § App. 2401-20 (1992)); Invention Secrecy Act of 1951, 66 Stat. 805 (1951) (codified at 35 U.S.C. §§ 181- 88 (1992)); Atomic Energy Act of 1954, 68 Stat. 921 (1954) (codified at 42 U.S.C. §§ 2011-2296 (1992)); Chen, *Tips on Export Controls Compliance*, Corporate Counsel's International Advisor, 107-05 (April 1, 1994); Ellenson, *A Primer on Export Control Compliance*, Cont. Mgmt., July 1992, at 11; Rose, *International Trade, Export Controls, and National Security: Can We Find a Proper Balance?* Cont. Mgmt., July 1988, at 16.

<sup>33</sup>22 C.F.R. §§ 120.21, 120.22 and Part 124 (1993).

<sup>34</sup>19 U.S.C. § 1673-73I (1992); see also 15 U.S.C. § 72 (1992); 19 U.S.C. §§ 160-71 (1992); McGee, *The Case to Repeal the Antidumping Laws*, 13 J. Int'l L. Bus. 491 (1993)

<sup>35</sup>19 U.S.C. §§ 1303, 1671-77 (1992). See also Andoh, *Countervailing Duties in a Not Quite Perfect World*, 44 Stan. L. Rev. 1515 (1992).

<sup>36</sup>See, e.g., 15 U.S.C. §§ 1 & 2 (1992). See also Comment, *International Trade and Unfair Imports: Price Discrimination and Predation Analysis in Antitrust and International Trade*, 61 U. Cin. L. Rev. 877 (1993).

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<sup>37</sup>12 C.F.R. §§ 401(c) & 402(d). The Export-Import Bank was established by Executive Order No. 6581 on February 2, 1934. The basic legislative underpinning for the Bank is the Export-Import Bank Act of 1945, 59 Stat. 526 (codified at 12 U.S.C. §§ 635 *et. seq.* (1992)). Its purpose was to help finance the sale of U.S. commercial products to foreign buyers through the use of loan guarantees or direct loans. The 1990 Foreign Operations, Export Financing, and Related Programs Appropriations Act, Pub. L. No. 101-167, 103 Stat. 1195, 1215-16 (1989), which was enacted on November 21, 1989, authorized the Export-Import Bank to make loan guarantees available for a limited period of time to Greece and Turkey for purchases of defense articles and services. *See also EXIMBANK Backs Two Defense-Related Sales*, 54 Fed. Cont. Rep. (BNA) 536 (Oct. 8, 1990). This authority expired on September 30, 1991. On March 7, 1991, the Bush Administration proposed an amendment to the Export-Import Bank Act of 1945 authorizing \$1 billion in loan guarantees for the direct commercial sale of military items to NATO Countries, Australia, Japan, and Israel. 55 Fed. Cont. Rep. (BNA) 617 (May 6, 1991). *See also Williams, Plan to Underwrite Defense Exports Draws Fire*, 91-4 Costs, Pricing & Accounting Rep. (Fed. Pubs. Inc.) 17 (Apr. 1991). The Administration withdrew its support for the measure in May 1991. *Administration Backs Off on EXIMBANK Proposal*, 55 Fed. Cont. Rep. (BNA) 686 (May 20, 1991). Under the current version of the law, the Export-Import Bank is barred from providing loan guarantees or direct loans for the sales of military items unless there has been a Presidential determination of national interest, the determination is reported to Congress, and the sale relates to drug enforcement activities. 12 U.S.C. § 635(b)(6)(1992). *See also SAMM 9004.E.*

<sup>38</sup>The Defense Production Act Amendments of 1984, Pub. L. No. 98-265, §6, 98 Stat. 149, 152 (codified at 50 U.S.C. § 2099 (1992)), imposed a duty on the president to submit an annual report to Congress on the impact of offsets to U.S. employment, trade, industrial competitiveness, and defense preparedness. *See also Exec. Order No. 12,919*, 59 Fed. Reg. 29525 (June 3, 1994). The Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 2205, 102 Stat. 1107, 1332-33 (1988) (codified at 15 U.S.C. § 4712 (1992)), established a new office within the Department of Commerce's International Trade Administration to focus only on countertrade and barter issues. *See generally Sen. Dixon, Rep. Oakar Drafting Bills to Limit Offsets*, 49 Fed. Cont. Rep. (BNA) 214 (Feb. 8, 1988). The 1989 Defense Authorization Act, Pub. L. No. 100-456, § 825, 102 Stat. 1918, 2020-22 (1988) (codified at 10 U.S.C. § 2532)(1992), required the President to develop a policy on foreign contract offset arrangements with an emphasis on the effect such arrangements have on the U.S. industrial base. The law also imposes a duty on the President to notify Congress any time a U.S. company enters into a contract over \$50 million to sell a weapon system or defense-related system and that contract is subject to an offset arrangement. *Id. See also Commerce Seeks Views on Military Offset*, 53 Fed. Cont. Rep. (BNA) 79 (Jan. 15, 1990); [1990] *U.S. Code Cong. & Admin. News*, 2503, 2560-61; *Offset Legislation Has Not Been Implemented*, 55 Fed. Cont. Rep. (BNA) 64 (Jan. 21, 1991). The original version of the law required the President to prepare periodic reports to Congress on the status of U.S. efforts to negotiate agreements with foreign countries on offsets. In accordance with SAMM 140107.C, DoD prepares its own semiannual report on the status of offset arrangements. The Defense Production Act Amendments of 1992, Pub. L. No. 102-558, §123, 106 Stat. 4198, 4207 (1992) (codified at 50 U.S.C. App. § 2099 (1992) require contractors to notify the Department of Commerce of each contract for the sale of a weapon system or defense-related item if it contains an offset agreement in excess of \$5 million. The Department of Commerce, in turn, must submit an annual report to Congress on such offset agreements. The legislative history indicated that the Act was intended "to codify the President's offset policy, which recognizes offsets for military purposes as economically inefficient and market distorting and states that no agency of the United States Government shall encourage, enter directly into, or commit U.S. firms to any offset arrangement." 1992 *U.S. Code Cong. & Admin. News*, 3508, 3515. The proposed implementing Department of Commerce Regulations were published for comment in 59 Fed. Reg. 21678 (Apr. 26, 1994).

<sup>39</sup>Pub. L. No. 94-329, *supra* note 32.

<sup>40</sup>*Sen. Feingold Probes Charge that Northrop Undercut U.S. Firm to Help Finnish Offset*, 10 Int'l Trade Rep. (BNA), Mar. 10, 1993, at 430.

<sup>41</sup>*DoD, Commerce Find Northrop Broke No Laws in Undercutting U.S. Firm to Further Offset*, *supra* note 20.

<sup>42</sup>140 Cong. Rec. S187 (Jan. 25, 1994).

<sup>43</sup>Pub. L. No. 103-236, §§ 732-33, 108 Stat. 382 (1994) (to be codified at 22 U.S.C §§ 2776 & 2779).

<sup>44</sup>Section 732 of Pub. L. No. 103-236 reads: (a) Numbered certifications with respect to government-to-government sales. Section 36(B)(1) of the Arms Export Control Act (22 U.S.C. 2776(b)(1)) is amended - (1) By inserting after the second sentence the following new sentence: 'Each such numbered certification shall contain an item indicating whether any offset agreement is proposed to be entered into in connection with such letter of offer to sell (if known on the date of transmittal of such certification);' and (2) In subparagraph (c) by inserting 'and a description from such contractor of any offset agreements proposed to be entered into in connection with such sale' after 'sold'. (b)

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Numbered certifications with respect to commercial exports. Section 36(C)(1) of the Arms Export Control Act (22 U.S.C. 2776(c)(1)) is amended - (1) By inserting after the first sentence the following new sentence: 'Each such numbered certification shall also contain an item indicating whether any offset agreement is proposed to be entered into the connection with such export (if known on the date of transmittal of such certification).'; and (2) In the third sentence by inserting 'and a description from the person who has submitted the license application of any offset agreement proposed to be entered into in connection with such export (if known on the date of transmittal of such statement)' after 'Secretary of Defense'. (c) Definitions. Section 36 of the Arms Export Control Act (22 U.S.C. 2776) is amended by adding at the end the following: (E) For purposes of this section - (1) The term 'offset agreement' means an agreement, arrangement, or understanding between a United States supplier of defense articles or defense services and a foreign country under which the supplier agrees to purchase or acquire, or to promote the purchase or acquisition by other United States persons of, goods or services produced, manufactured, grown, or extracted, in whole or in part, in that foreign country in consideration for the purchase by the foreign country of defense articles or defense service from the supplier; and (2) The term 'United States person' means - (a) An individual who is a national or permanent resident alien of the United States; and (b) Any corporation, business association, partnership, trust, or other juridical entity - (i) Organized under the laws of the United States or any state, district, territory, or possession thereof; or (ii) Owned or controlled in fact by individuals described in Subparagraph (A). See *SAMM* 70302-70304.

<sup>45</sup>Section 733 of Pub. L. No. 103-236 amended the Arms Export Control Act (22 U.S.C. 2779) is amended by inserting after section 39 the following new section: SEC. 39A. PROHIBITION ON INCENTIVE PAYMENTS. (a) No United States supplier of defense articles or services sold under this Act, nor any employee, agent, or subcontractor thereof, shall, with respect to the sale of any such defense article or defense service to a foreign country, make any incentive payments for the purpose of satisfying, in whole or in part, any offset agreement with that country. (b) Any person who violates the provisions of this section shall be subject to the imposition of civil penalties as provided for in this section. (c) In the enforcement of this section, the President is authorized to exercise the same powers concerning violations and enforcement and imposition of civil penalties which are conferred upon departments, agencies and officials by subsections (c), (d), (e), and (f) of section 11 of the Export Administration Act of 1979 [50 U.S.C. App. 2410(c), (d), (e), & (f)] and section 12(a) of such Act [50 U.S.C. App. 2411(a)], subject to the same terms and conditions as are applicable to such powers under that Act, except that notwithstanding section 11(c) of that Act, the civil penalty for each violation of this section may not exceed \$500,000 or five times the amount of the prohibited incentive payment, whichever is greater. (d) For purposes of this section - (1) the term 'offset agreement' means an agreement, arrangement, or understanding between a United States supplier of defense articles or defense services and a foreign country under which the supplier agrees to purchase or acquire, or to promote the purchase or acquisition by other United States persons of, goods or services produced, manufactured, grown, or extracted, in whole or in part, in that foreign country in consideration for the purchase by the foreign country of defense articles or defense services from the supplier; (2) the term 'incentive payments' means direct monetary compensation made by a United States supplier of defense articles or defense services or by any employee, agent or subcontractor thereof to any other United States person to induce or persuade that United States person to purchase or acquire goods or services produced, manufactured, grown, or extracted, in whole or in part, in the foreign country which is purchasing those defense articles or services from the United States supplier; and (3) the term 'United States person' means - (A) an individual who is a national or permanent resident alien of the United States; and (B) any corporation, business association, partnership, trust, or other juridical entity - (i) organized under the laws of the United States or any State, the District of Columbia, or any territory or possession of the United States; or (ii) owned or controlled in fact by individuals described in subparagraph (A).

<sup>46</sup>See 22 U.S.C. § 2778(e)(1992); 50 U.S.C. App. § 2410 (1992); See also 22 U.S.C. § 2778(c) (1992); 18 U.S.C. § 1001 (1992).

<sup>47</sup>59 Fed. Reg. 17756 (Apr. 14, 1994); 59 Fed. Reg. 21678 (Apr. 26, 1994).

<sup>48</sup>50 U.S.C. § 2099 (1992); see also note 38 *supra*.

<sup>49</sup>59 Fed. Reg. 21678 (Apr. 26, 1994). A report would be required on (a) any sale subject to an offset agreement in excess of \$5 million and (b) any offset transactions for which the contractor received credit in fulfillment of an offset agreement in excess of \$5 million. *Id.*

<sup>50</sup>See note 27 *supra*.

<sup>51</sup>See note 25 *supra*.

<sup>52</sup>32 I.L.M. 605 (1993); North American Free Trade Agreement Implementation Act, Pub. L. No. 103-182, 107 Stat. 2057 (1993) (codified at 19 U.S.C. §§ 3301-3473 (1992) (hereinafter NAFTA); see also Judith H. Bello & Alan F. Holmer, *The NAFTA: Its Overarching Implications*, 27 Int'l Law. 589 (1993). An excellent history of NAFTA can

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be found in Judith H. Bello & Alan F. Holmer, *U.S. Trade and Policy Series No. 23: Reflections on the NAFTA as a Turning Point in American Foreign Policy*, 28 Int'l Law. 425 (1994). See also Diamond & Maxwell, *Opening the International Government Marketplace: New Developments on the NAFTA, U.S., E. C. and GATT Fronts*, 62 Fed. Cont. Rep. (BNA) (Supp.), S-1 (July 25, 1994). NAFTA was executed by President Bush, President Salinas, and Prime Minister Mulroney on December 17, 1992. NAFTA was enacted into U.S. law on December 8, 1993. As between Canada and the U.S., NAFTA represents an expansion of the governmental entities that previously were covered by the government procurement sections of the 1988 U.S.—Canada Free Trade Agreement (CFTA), 27 I.L.M. 281 (1988), and the Agreement on Government Procurement (GATT Procurement Code) [Tokyo Round], 1 B.D.I.E.L. (CCH) 171 (1979). See also U.S.—Canada Free-Trade Agreement Implementation Act of 1988, Pub. L. No. 100-449, 102 Stat. 1851; Trade Agreements Act of 1979, Pub. L. No. 96-39, 93 Stat. 144 (codified at 19 U.S.C. §§ 2501-82 (1992)) (implementing the GATT Tokyo Round agreement). It should be noted that NAFTA did not replace the CFTA or GATT. NAFTA art. 103. In the event of any inconsistency, NAFTA takes precedence. *Id.* See also note 65 *infra*. However, section 107 of the North American Free Trade Agreement Implementation Act, *supra*, provides for authority to suspend the CFTA upon the entry into force of NAFTA. 1993 U.S. Code Cong. & Ad. News, 2552, 2757; 19 U.S.C. § 2112 (1992).

<sup>53</sup>NAFTA, *supra* note 52, art. 1006 provides: Each Party shall ensure that its entities do not, in the qualification and selection of suppliers, goods or services, in the evaluation of bids or the award of contracts, consider, seek or impose offsets. For purposes of this Article, offsets means conditions imposed or considered by an entity prior to or in the course of its procurement process that encourage local development or improve its Party's balance of payments accounts, by means of requirements of local content, licensing of technology, investment, counter-trade or similar requirements.

<sup>54</sup>Chierichella & Maxwell, *Government Procurement under the North American Free Trade Agreement*, 58 Fed. Cont. Rep. (BNA) 487, 493-92 (Oct. 26, 1992). To be sure, the "federal government entities," covered by NAFTA include Canada's Department of National Defence, Mexico's Ministry of National Defense and Ministry of the Navy, and the U.S. Department of Defense (DoD) and National Aeronautics and Space Administration (NASA). NAFTA Annex 1001.1a-1. However, the national security exception and limited list of eligible products and services severely restricts NAFTA's application to military procurements. See notes 56 & 57 *infra*.

<sup>55</sup>NAFTA, *supra* note 52, art. 1018 provides: 1. Nothing in this Chapter shall be construed to prevent a Party from taking any action or not disclosing any information which it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition or war materials, or to procurement indispensable for national security or for national defense purposes. 2. Provided that such measures are not applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between Parties where the same conditions prevail or a disguised restriction on trade between the Parties, nothing in this Chapter shall be construed to prevent any Party from adopting or maintaining measures: (a) necessary to protect public morals, order or safety; (b) necessary to protect human, animal or plant life or health; (c) necessary to protect intellectual property; or (d) relating to goods or services of handicapped persons, of philanthropic institutions or of prison labor.

<sup>56</sup>NAFTA *supra* note 52 Annex 1001.1b-1. Examples of listed products are railway equipment, certain motor vehicles, tractors, tires, metal working equipment, rope, cable, electrical wire, certain instruments and laboratory equipment, furniture, and general purpose automatic data processing equipment. *Id.* See also DFARS 225.403-70. These products are consistent with the products listed as covered under the 1979 GATT Procurement Code and the CFTA. Chierichella & Maxwell, *supra* note 55, at 492. See also note 52 *supra*, note 65 *infra*.

<sup>57</sup>NAFTA 0 note 52, Annex 1001.1b-2. But see note 62 *infra* and accompanying text. See also Chierichella & Maxwell, *supra* note 55, at 492.

<sup>58</sup>NAFTA *supra* note 52, Annex 1001.1b-3-A; see also Chierichella & Maxwell, *supra* note 55, at 492.

<sup>59</sup>NAFTA *supra* note 52, Annex 1001.1b-3, Section B.

<sup>60</sup>NAFTA *supra* note 52, Annex 1001.2b provides, in pertinent part: 6. Notwithstanding any other provision of this Chapter, an entity may impose a local content requirement of no more than: (a) 40 percent, for labor-intensive turnkey or major integrated projects; or (b) 25 percent, for capital-intensive turnkey or major integrated projects. For purposes of this paragraph, a turnkey or major integrated project means, in general, a construction, supply or installation project undertaken by a person pursuant to a right granted by an entity with respect to which: (c) the prime contractor is vested with the authority to select the general contractors or subcontractors, (d) neither the Government of Mexico nor its entities fund the project; (e) the person bears the risks associated with non-performance; and (f) the facility will be operated by an entity or through a procurement contract of that entity.

<sup>61</sup>NAFTA *supra* note 52, Annex 1001.1b-2, Appendix 1001.1b-2-A.

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<sup>62</sup>Federal Acquisition Circular (FAC) 90-19, 59 Fed. Reg. 544 (Jan. 5, 1994); FAR Subpart 25.4; FAR 52.225-20; FAR 52.225-21; 59 Fed. Reg. 1288 (Jan. 10, 1994); DFARS Subpart 225.4; DFARS 252.225-7006; DFARS 252.225-7007.

<sup>63</sup>33 I.L.M. 1 (1994). The agreement was reached on December 15, 1993; however, Congress must still enact legislation implementing the agreement.

<sup>64</sup>Cedric Guyot, *Countertrade Contracts in International Business*, 20 Int'l Law. 921, 923-24 (1986). Guyot proffered the following comments on the effect of GATT on countertrade: One of the main international agreements being affected by the surge of countertrade is the General Agreement for Tariffs and Trades (GATT). While finding that countertrade does not, *per se*, contravene GATT rules, GATT officials point out that 'in some specific circumstances in which governmental measures require, stimulate, take the form of or react to countertrade, those measures could be inconsistent with obligation under GATT policies.' Balancing trade between two countries is not expressly forbidden by GATT, but the language of GATT's articles condemns forced balancing of exports and imports when unilaterally imposed conditions on Trade Transaction as a violation of the duty of 'nondiscriminatory treatment.' But even if one finds violations of the GATT rules, there is the question of how a real violation of the GATT can be pursued and remedied. Also, the countries enacting regulations and forcing countertrade can cite for support of their decision Article XII of GATT which authorizes exceptions in the event of economic difficulties. *Id.* (all footnotes omitted). In discussing how the new GATT procurement code represents an improvement over prior GATT agreements, the President of the United States said "this is a substantial improvement over the existing Code, which authorizes offsets." *Executive Summary: Results of the GATT Uruguay Round of Multilateral Trade Negotiations*, reprinted in, 58 Fed. Reg. 67263, 67301 (Dec. 17, 1993).

<sup>65</sup>*Agreement on Government Procurement (GATT Procurement Code) [Tokyo Round]*, *supra* note 52. For purposes of DoD procurement, the Trade Agreements Act of 1979, *supra* note 52, removed Buy American Act barriers for only those specific items (mostly of a nonmilitary nature) listed in DFARS 225.403-70. *See also* FAR Subpart 25.1; FAR Subpart 25.2; FAR Subpart 25.4; 41 U.S.C. § 10 (1992); Exec.Ord. No. 10582 (Dec. 17, 1954) (as amended). The list of products subject to the new GATT Government Procurement Code will probably remain the same as those under the old Code and the new NAFTA agreement. *See* DFARS 225.403-70, note 57 *supra*.

<sup>66</sup>The national security exception reads as follows: 1. Nothing in this Agreement shall be construed to prevent any Party from taking any action or not disclosing any information which it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition or war materials, or to procurement indispensable for national security or for national defense purposes. 2. Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent any Party from imposing or enforcing measures necessary to protect public morals, order or safety, human, animal or plant life or health, intellectual property, or relating to the products of handicapped persons, of philanthropic institutions or of prison labour. *Agreement on Government Procurement (Government Procurement Code) [Tokyo Round]*, *supra* note 52, at art. VIII.

<sup>67</sup>Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, reprinted by Office of the U.S. Trade Representative, Dec. 15, 1993. The Uruguay Round GATT Agreement was signed in Marrakesh by over 100 countries on April 15, 1994. It is scheduled to go into effect on July 1, 1995. Under the terms of Part II, Annex 1A. Agreement on Trade in Goods - 16 Agreement on Technical Barriers to Trade, Article 1.4, as well as Part II, Annex 1B. General Agreement on Trade in Services, Article XIII, the basic Uruguay Round GATT Agreement does not apply to government procurement. However, the new GATT "Agreement on Government Procurement," which was negotiated in parallel with the basic GATT agreement does apply to certain government procurements. *See* note 68 *infra*.

<sup>68</sup>GATT Doc. GPR/Spec 77 (Dec. 15, 1993). Only twelve signatories were reported to have agreed to comply with the new GATT Agreement on Government Procurement: Austria, Canada, European Union, Finland, Hong Kong, Israel, Japan, Korea, Norway, Sweden, Switzerland, and the U.S. Hong Kong later declined to sign. Diamond & Maxwell, *supra* note 52, at S-20, n. 75. The agreement goes into effect for Korea on January 1, 1997. For the rest of the signatories, the agreement is effective on January 1, 1996. The new GATT Agreement "replaces the existing GATT Government Procurement Agreement, expanding the coverage to include services and construction as well as goods, and purchasing by some subcentral governments (including 37 States) and government-owned utilities as well as Federal entities." *Testimony May 16, 1994 Initial Draft Implementing Committee on Ways and Means/Trade Subcommittee Consideration: GATT Legislation*, Fed. Doc. Clearing House, May 16, 1994. It should be noted that GATT agreements are not classified as treaties. Accordingly, while the advice and consent of the U.S. Senate is not required, Congress must still enact implementing legislation in order for GATT to go into effect. 19 U.S.C. §

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2903(a)(1) (1992). In conjunction with the negotiation of this new GATT Procurement Code, the U.S. and the European Union concluded an agreement on April 15, 1994, to open up their respective public procurement markets. 11 Int'l Trade Rep. (BNA) 627 (Apr. 20, 1994); *USTR Address Discriminatory Foreign Government Procurement Practices and Expanded GATT*, 36 Gov't Contractor (Fed. Pubs. Inc.) 10, 11 (May 25, 1994).

<sup>69</sup>Agreement on Government Procurement [GATT Uruguay Round], *supra* note 67, art. XVI, provides: 1. Entities shall not, in the qualification and selection of potential suppliers, service providers, products or services, or in the evaluation of tenders and award of contracts, impose, seek or consider offsets. Offsets in government procurement are measures used to encourage local development or improve the balance-of-payments accounts by means of local content, licensing of technology, investment requirements, counter-trade or similar requirements. 2. Nevertheless, having regard to general policy considerations, including those relating to development, developing countries may at the time of accession negotiate conditions for the use of offsets, such as requirements for the incorporation of domestic content. Such requirements shall be used only for qualification to participate in the procurement process and not as criteria for awarding contracts. Conditions shall be objective, clearly defined and non-discriminatory. They shall be set forth in an Annex to this Agreement and may include precise limitations on the imposition of offsets in any contract subject to this Agreement. The existence of such conditions shall be notified to the MTO Secretariat and included in the notice of intended procurement and other documentation. (footnotes omitted). See also *U.S., EU Disagree on Scope of GATT Public Procurement Pact*, Int'l Trade Daily (BNA), Jan. 6, 1994.

<sup>70</sup>Agreement on Government Procurement [GATT Uruguay Round], *supra* note 67, art. XXIII, states: 1. Nothing in this Agreement shall be construed to prevent any Party from taking any action or not disclosing any information which it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition or war materials, or to procurement indispensable for national security or for national defense purposes.

2. Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent any Party from imposing or enforcing measures necessary to protect public morals, order or safety, human, animal or plant life or health, intellectual property, or relating to the products or services of handicapped persons, of philanthropic institutions or of prison labour. The basic Uruguay Round GATT Agreement, *supra* note 67, also contains a number of exceptions for national security and certain Government subsidies. Part II, Annex 1A, "Agreement on Trade in Goods 13—Agreement on Subsidies and Countervailing Measures," Article 8; Part II, Annex 1A, Agreement on Trade in Goods - 6 Agreement on Technical Barriers to Trade, Preamble; Part II, Annex 1B, General Agreement on Trade in Services, Article XIV bis. The U.S. Government recently invoked the GATT exceptions to permit DoD to promote the domestic development of computer flat panel displays, a market dominated by the Japanese. George Will, *Up From Mercantilism—GATT Enlarges Americans' Sovereignty Without Harming America's*, Newsweek, May 30, 1994 at 76; see also *GATT Agreement is Flawed in Subsidy Language, Danforth Says*, Daily Report for Executives (BNA), May 27, 1994; *U.S. Plan to Develop Flat Panel Screens Could Widen 'Subsidies War', Aide Says*, Daily Report for Executives (BNA), June 3, 1994.

<sup>71</sup>The U.S. and Foreign Commercial Service, American Embassy Kuwait, issued a publication on May 23, 1994, describing the establishment of "The Kuwait Corporate Training Center (KCTC)." The KCTC will be operated by a Kuwaiti limited-liability company called the KCTC Management Company, which is 100% owned by Middle Eastern investors. The KCTC Management Company will enter into joint ventures with U.S. contractors that are looking to satisfy their offset obligations to the Kuwaiti Government. More information on the program is available from the Commercial Attache, American Embassy Kuwait. In November 1991 California established an "offset bank" to monitor state purchases overseas and make "offset credits" available to California companies with foreign offset obligations. *California to Demand Offsets from Foreign Suppliers*, 160 Aerospace Daily 264 (Nov. 18, 1991). However, this California "offset bank" has assumed an inactive status.