

The Big Payback:
How Corruption Taints Offset Agreements in International Defense Trade
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Abstract

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A defense offset is an agreement between a defense vendor and a foreign government where the vendor commits to performing specific future business in the foreign country in exchange for the award of a defense contract. It is an incentive agreement that encourages the award of a defense procurement to a specific vendor. Offsets are an accepted practice in international defense trade; however, a recent investigation by the Serious Fraud Office in the United Kingdom has revealed that corruption in defense offsets is a significant problem. Specifically, investigation has shown that offsets have been exploited for bribes and sham transactions that potentially involve billions of dollars in trade.

This thesis argues that because offsets have large monetary values, are not transparent, and involve complex transactions, they are highly vulnerable to being manipulated for corrupt purposes, and that the corruption revealed in the United Kingdom is not a one-off event. This is especially so because offsets are not effectively regulated by governments engaging in offset trade. To stop corrupt offset activity, the international community and defense industry need to create a new set of rules that better manage and police offset agreements. Specifically, the Organization for Economic Cooperation and Development should begin negotiating a convention of best practices for defense offsets so that offsetting governments can begin reforming their own laws, and so the international community can establish a set of offset norms. Additionally, defense vendors should increase their due diligence and auditing standards to deter and detect offset corruption,

and to avoid criminal liability under the Foreign Corrupt Practices Act, U.K. Bribery Act, and other anti-corruption laws.

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I. INTRODUCTION

When Parliament in the United Kingdom was debating the U.K. Bribery Act of 2010, corruption in the defense industry was one of the main catalysts for their debate.¹ Between 2003 and 2006, a Serious Fraud Office (SFO) investigation of BAE Systems—a major British aerospace firm—discovered that for over 20 years, BAE Systems distributed £6 billion (\$9.7 billion) in corrupt commissions to members of the Saudi royal family through agents and middlemen in exchange for the award of defense contracts totaling £43 billion (\$69.4 billion).² This astronomical amount in bribes was paid for, at least in part, by BAE Systems receiving fraudulent payment for inflated bills submitted to the Saudi government; in one contract, the price of an airplane was inflated 32 percent to allow for an initial £600 million (\$970 million) in commissions.³ The fraudulent commissions to the Saudi royal family, in short, were paid for by stealing from the Saudi treasury.⁴ As the SFO further investigated BAE Systems, more allegations of bribery emerged, including an allegation of 24 million Rand in bribery (\$3 million) from BAE

¹ JOINT COMMITTEE ON THE DRAFT BRIBERY BILL, DRAFT BRIBERY BILL, 2008-9, H.L. 115-I, H.C. 430-I, at 13 (U.K.); see MINISTRY OF JUSTICE, BRIBERY ACT 2010, 2010, CIRCULAR 2011/05, at 2 (U.K.) (passage of U.K. Bribery Act 2010).

² David Leigh and Rob Evans, *Secrets of Al-Yamamah*, THE GUARDIAN, <http://www.guardian.co.uk/baefiles/page/0,,2095831,00.html> (last visited August 7, 2012) [hereinafter Leigh and Evans, *Al-Yamamah*]; David Leigh and Rob Evans, *Nobbing the Police*, THE GUARDIAN, <http://www.guardian.co.uk/baefiles/page/0,,2098531,00.html> (last visited August 7, 2012); see THE MONEY CONVERTER, <http://themoneyconverter.com/gbp/usd.aspx>, (last visited May 9, 2012), for conversion from U.K. pounds to U.S. dollars. The contracts in question were collectively called the “Al Yamamah” contracts, and involved the sale of fighter aircraft and jet trainers, the construction of two air bases, and the provision of a host of other equipment and services by BAE Systems for the government Saudi Arabia. David Pallister, *The Arms Deal They Called The Dove: How Britain Grasped The Biggest Prize*, THE GUARDIAN, Dec. 14, 2006, at 9. The deal was entered into in 1988, and was eventually worth a total of £43 billion (\$69.4 billion). Leigh and Evans, *Al-Yamamah*; The Money Converter.

³ Leigh and Evans, *Al-Yamamah*, supra note 2; see The Money Converter, supra note 2, for conversion from U.K. pounds to U.S. dollars.

⁴ Pallister, supra note 2, at 9.

Systems and its joint venture partner, Saab, to the government of South Africa.⁵ The allegations centered around an arcane practice in defense trade—the use of a reciprocal transaction, or “offset”—in the satisfaction of BAE Systems’ contractual obligations to South Africa.⁶ Specifically, BAE Systems allegedly used a consultant to pay bribes to South African officials to not only receive a fighter jet procurement contract, but also to receive discharge of obligations incurred in the reciprocal offset agreement.⁷ As the South African’ government’s investigation into BAE Systems’ alleged bribes continues,⁸ a new question is now raised among anti-corruption advocates: what are defense offsets, and how susceptible are they to corruption?

A defense offset is an agreement to do specific future business in a country in exchange for the award of a government contract.⁹ In a 2010 report, Transparency International (TI) concluded defense offsets are highly susceptible to corrupt activities due to their high transactional value, lack of transparency, and highly technical nature, and that these risk factors enable corrupt government officials and firms to engage in bribery to create unnecessary offset deals, bribery to award offsets to particular suppliers,

⁵ Sam Sole and Stefaans Brümmer, *BAE’s ‘Bribery’ Channel*, MAIL & GUARDIAN (SOUTH AFRICA), (Jun. 24, 2011), <http://mg.co.za/article/2011-06-24-baes-bribery-channel>; Ivor Powell, *‘Consultant’ at Centre of Arms Bribery Scandal*, ARGUS WEEKEND (SOUTH AFRICA), Jun. 19, 2011, at NEWS, pg 4. See The Money Converter, *supra* note 2, for South African Rand/U.S. dollar conversion.

⁶ Sole and Brümmer, *supra* note 5; Stephen Martin, *Countertrade And Offsets: An Overview Of The Theory And Evidence*, in THE ECONOMICS OF OFFSETS: DEFENSE PROCUREMENT AND COUNTERTRADE 15, 15, 31 (Stephen Martin, ed. 1996).

⁷ Sole and Brümmer, *supra* note 5.

⁸ *South Africa Reopens 1999 Arms Deal Investigation*, BBC, (Sep. 15, 2011), <http://www.bbc.co.uk/news/world-africa-14939077>.

⁹ Martin, *supra* note 6, at 15, 31; U.S. DEP’T OF COMMERCE, OFFSETS IN DEFENSE TRADE: SIXTEENTH STUDY 1 (2012) [hereinafter DEP’T OF COMMERCE, SIXTEENTH STUDY]; U.S. GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, MILITARY EXPORTS: OFFSET DEMANDS CONTINUE TO GROW 1 (1996) [hereinafter GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65].

and theft of funds from offset packages.¹⁰ However, TI's report only scratched the surface of how corruption works in defense offsets.

To clarify how corruption taints offset transactions, this thesis will argue that fraudulently inflated offset valuations, improper sole sourcing, and a lack of transparency in offset awards and discharges are the key elements that make defense offsets exploitable for corruption. To combat the problem of corruption in defense offsets, the international community and the defense industry must both take action to curb abusive offset practices, and to do a better job of preventing corruption. Specifically, the Organization for Economic Cooperation and Development (OECD) should begin negotiations for a convention to set out basic standards for offset procurements in order to reduce corruption in defense offsets. In addition, defense vendors should institute targeted offset compliance measures that heighten due diligence verification standards and increase electronic audits of offset partner documents.

To analyze the problem of corruption in defense offsets, this thesis is organized into five sections. The first section describes the corruption risks imposed by offsets, as well as the basics of an offset transaction. The second section summarizes offset regulations in the two largest defense markets, the United States and European Union, as well as offset rules created by the World Trade Organization (WTO). The third section discusses criminal statutes that punish bribery and false claims in offset transactions. These statutes include the Foreign Corrupt Practices Act (FCPA), U.K. Bribery Act, and the False Claims Act. The fourth section analyzes how corrupt purposes can manipulate offset transactions through valuation, competition and transparency flaws. Finally, the

¹⁰ TRANSPARENCY INT'L, DEFENSE OFFSETS: ADDRESSING THE RISKS OF CORRUPTION & RAISING TRANSPARENCY 18, 43 (2010) (hereinafter TRANSPARENCY INT'L, DEFENSE OFFSETS).

last section proposes new initiatives that the OECD and defense vendors should implement to reform defense offsets.

II. CORRUPTION RISKS IN DEFENSE OFFSETS

Offsets are a complex and arcane aspect of defense trade, so an introduction of what they are, and the policies behind them, is necessary to discuss their corruption risks.

A defense offset is a compensation agreement where a defense vendor promises to do specific future business in a country in exchange for the award of a government procurement contract for a major weapon system.¹¹ It is a reciprocal transaction that allows the economy of the purchasing government to recoup, or “offset,” some of the purchase price of the procured defense item.¹² An offset agreement is made between a defense vendor and a purchasing government, but it involves the vendor placing work with a company located in the purchasing country.¹³ Vendors and governments agree to offsets within the broader context of negotiating the sale of a major weapon system, usually in the aerospace and communications sectors, and offsets may be offered as an inducement by a vendor, or a condition by a purchaser.¹⁴ The business occurring in an offset arrangement is dependent on the successful negotiation of the defense sale; without the defense sale, the offset transaction would not occur on the open market, or would occur at a much higher cost to the purchasing government.¹⁵ However, without the

¹¹ Martin, *supra* note 6, at 15, 31; DEP’T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 1; GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 1.

¹² See Jurgen Brauer and J. Paul Dunne, *Introduction*, in *ARMS TRADE AND ECONOMIC DEVELOPMENT* 1, 3 (Jurgen Brauer and J. Paul Dunne eds., 2004) (citing Bernard Udis and Keith E. Maskus, *Offsets As Industrial Policy: Lessons From Aerospace*, DEFENCE ECONOMICS, Vol. 2, No. 2, at 152 (1991) (offsets allow purchasing governments to recoup, or offset, some of their investment)).

¹³ *Id.* at 4.

¹⁴ DEP’T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 7-8; GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 1, 2.

¹⁵ Lloyd J. Dumas, *Do Offsets Mitigate Or Magnify The Military Burden?*, in *ARMS TRADE AND ECONOMIC DEVELOPMENT* 16, 22 (Jurgen Brauer and J. Paul Dunne eds., 2004).

inducement of an offset arrangement, the main defense sale may also not occur for a particular vendor, due to other defense firms outbidding the losing defense firm with more lucrative offset deals.¹⁶

The practice of offsets began in 1961, when the United States required West Germany to buy U.S. weapons to offset the economic impact of maintaining military forces in Germany.¹⁷ However, by the early 1970s, West European countries began conditioning their purchases of American goods to incentives such as job creation, technology transfer, and defense industrial base enhancement.¹⁸ By the 1980s, offset arrangements were present internationally, and countries such as South Korea asserted high offset demands; in a heated competition between General Dynamics and McDonnell-Douglas, for example, Korean offset demands escalated from 30 percent of the value of the contract price to 60 percent.¹⁹ At the present time, offsets are an integral part of sales negotiations in international defense trade; in an average contract, a U.S. vendor agrees to an offset worth 63.5 percent of the price of the defense sales contract.²⁰

Offsets, however, are prone to corruption. An offset agreement may be exploited for numerous illegal purposes, including bribes to generate an offset requirement, bribes to gain offset business, and bribes to satisfy offset obligations.²¹ Additionally, offset parties may submit fraudulent invoices to government officials for sham transactions.²² Offsets are susceptible to this corrupt activity due to four main reasons: they offer high-value

¹⁶ DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 1; see *Foreign Military Sales and Offsets: Hearing Before the H. Comm. On Energy And Commerce*, 99th Congress 3 (1985) (statement of Frank C. Conahan, General Accounting Office) (offsets as a marketing tool for foreign military sales).

¹⁷ Bernard Udis and Keith E. Maskus, *US Offset Policy*, in *THE ECONOMICS OF OFFSETS: DEFENCE PROCUREMENT AND COUNTERTRADE* 357, 358 (Stephen Martin ed., 1996).

¹⁸ *Id.* at 359; Martin, *supra* note 6, at 15, 34.

¹⁹ Udis and Maskus, *supra* note 17, at 363.

²⁰ DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 3.

²¹ TRANSPARENCY INT'L, *DEFENSE OFFSETS*, *supra* note 10, at 18-19.

²² *Id.*

inducements that are often tangential to the subject of a defense sale, they promote disparate policy goals that make them difficult to monitor, they use complex and opaque rules that frustrate accountability and transparency, and they require the hire of consultants who are often closely connected to government officials. Each of these factors, as shown below, have significant concerns to raise.

A. Questionable Inducements In Competitive Sales

Offsets are vulnerable to corruption because they distribute large sums of money as incentives in highly competitive, negotiated government procurements. Although these procurements involve major weapons systems costing billions of dollars, much of the offset work incentivizing these sales bears no direct relation to the basic defense item.²³ This disconnect between the subject of defense procurements and the subject of defense offsets raises a suspicion that offset incentives contain improper or corrupt inducements.

Defense offsets, like international defense sales as a whole, pose an attractive target to corruption due to the large amount of money involved in these business transactions.²⁴ Between 1993 and 2010, U.S. companies reported entering into over 11,000 offset transactions with an actual value of more than \$56 billion.²⁵ However, an offset's value is measured not only in dollars, but also in the percentage of the defense sale's actual value. For example, in February 2012 the Indian government agreed to purchase 126 fighter jets from the French company Dassault for up to \$20 billion.²⁶ To earn such a high-value

²³ See generally DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 3-4, 7-8 (defense sales and offset dollar amounts, indirect offsets accounting for 59.04 percent of U.S. offset transactions between 1993 and 2010, top four defense sectors participating in offsets).

²⁴ TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 4. From 1993 to 2010, the accompanying defense sales contracts numbered 763, and were worth \$111 billion. *Id.* at 3.

²⁵ DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 4.

²⁶ James Lamont and James Boxell, *India's Choice of a New Fighter Jet Reveals Hard Truths about a Promising Market – and the Risks for Politicians and Executives of Misreading It*, FINANCIAL TIMES (USA EDITION), Feb. 7, 2012, at 7.

deal, the French were willing to offer considerable concessions, including lowering the price of their fighters to \$5 million below the price of their competitors, offering side-deals on nuclear energy, and incurring offsets that were worth half the value of the contract.²⁷

Another key reason that offsets are so expensive is the highly competitive nature of international defense sales. Purchasing government exert considerable leverage to extract multiple concessions from defense firms, including offsets, because defense sales are rare and lucrative.²⁸ The life cycle of a major weapons system can run up to 30 years, so the award of a defense contract can lock in revenue for decades.²⁹ Additionally, because defense exports have traditionally been highly profitable, the international sale of a major weapons system can significantly boost a company's revenue.³⁰ Moreover, although the defense industry in the U.S. and Europe has undergone substantial consolidation since the 1990s, there remain enough defense firms internationally to offer fierce competition for major defense sales.³¹ For example, the competition for the sale of fighter jets to India initially involved rival bids from Boeing, Lockheed Martin, Dassault, and an EADS/BAE/Alenia Aeronautica consortium.³² In such a competitive environment, offerors are under considerable pressure to outbid their rivals' offset proposals.

Another factor driving the high value of offsets is that they have proven in the past to be a crucial deciding factor in defense procurements. The offset laws of some countries

²⁷ *Id.*

²⁸ See Travis Taylor, *Using Procurement Offsets As A Economic Development Strategy*, in *ARMS TRADE AND ECONOMIC DEVELOPMENT* 30, 31 (Jurgen Brauer and J. Paul Dunne eds., 2004) (purchasing government pressure to extract offset concessions).

²⁹ JEFFREY P. BIALOS ET AL., *FORTRESSES AND ICEBERGS: THE EVOLUTION OF THE TRANSATLANTIC DEFENSE MARKET AND THE IMPLICATIONS FOR U.S. NATIONAL SECURITY POLICY* 51 (2009).

³⁰ JACQUES GANSLER, *DEMOCRACY'S ARSENAL: CREATING A TWENTY-FIRST-CENTURY DEFENSE INDUSTRY* 66, 150-151 (2011).

³¹ *Id.* at 32-34, 150, 311.

³² Lamont and Boxell, *supra* note 26, at 7.

such as Poland, Hungary, Greece, and Portugal make offsets an award criterion that is taken into account as an aspect of overall bid evaluation.³³ Among the three critical components of a bid—the defense item itself, its price, and the offset package—the offset is the most flexible element and the most under the company’s control.³⁴ As a result, an offset proposal allows defense vendors to fashion creative proposals in order to win a sale.³⁵ For example, when Poland decided to purchase the F-16 in 2002, the bids among the procurements’ three competitors were scored on a 100-point scale, with 45 points for best price, 40 points for tactical and operational criteria, and 15 points for offsets; however, the bid differentials among the three proposals were 10 percent or less.³⁶ With only \$500 million separating the highest and lowest bids on a \$6 billion contract, and performance capabilities locked into aircraft with relatively similar capabilities, offsets (along with political and financial inducements) were one of the key factors in the award of the contract to Lockheed Martin.³⁷ Because of procurement decisions such as Poland’s acquisition of the F-16, offset advocates promote them as a useful “marketing tool” for defense vendors to win sales.³⁸

High-level negotiations for major weapon sales are still another factor contributing to offsets’ high valuation and vulnerability to corruption. Traditionally, negotiations have been disfavored in government procurements due to the perception that they are

³³ E. Anders Eriksson et al., *Study on the Effects of Offsets on the Development of a European Defence Industry and Market* 30 (2007); see also U.S. DEP’T OF COMMERCE, OFFSETS IN DEFENSE TRADE: TWELFTH STUDY at Appendix F (2007) (offsets as part of procurement decision) [hereinafter DEP’T OF COMMERCE, TWELFTH STUDY].

³⁴ Alon Redlich and Maison Miscavage, *The Business Of Offset: A Practitioner’s Perspective*, in THE ECONOMICS OF OFFSETS: DEFENCE PROCUREMENT AND COUNTERTRADE 381, 393 (Stephen Martin ed., 1996).

³⁵ *Id.*

³⁶ Barre R. Seguin, *Why Did Poland Choose the F-16?*, George C. Marshall European Center For Security Studies Occasional Paper No. 11, at 11, 16 (2007).

³⁷ *Id.* at 11, 16, 30-31. The three bidders in the Polish procurement were the Lockheed Martin F-16, Saab/BAE Systems JAS-39 Gripen, and the Dassault Mirage 2000-5 Mk II. *Id.* at 5.

³⁸ *Foreign Military Sales and Offsets*, supra note 16, at 3; Dumas, supra note 15, at 16.

vulnerable to unjust favoritism, collusion, and fraud, as well as being a means of enabling the covert payment of bribes.³⁹ In defense offsets, this traditional perception has merit due to offsets being negotiated with high-ranking government officials, and due to local politicians inserting themselves into offset negotiations.⁴⁰ During the Polish negotiations for the F-16, for example, a bribery scandal involving military procurements resulted in the suspension of the Polish Deputy Defense Minister.⁴¹ In addition, the Polish offices of the President and Prime Minister interjected themselves into the negotiation process to promote favorite offset projects and to seek assurances that their political districts would become offset beneficiaries.⁴² Such a situation is a textbook example of a transaction with a high risk for corruption.⁴³ Because a typical offset negotiation may take several months, with hundreds of meetings, in order to arrive at a total offset package, vendors face a significant temptation when presented with a politically motivated offset proposal—will they concede to it, or allow their negotiation to fail?⁴⁴ The risk of corruption is further exacerbated by the fact that some of the top purchasers of defense equipment and offsets are located in regions, such as the Middle East, that face significant corruption problems.⁴⁵

³⁹ STEVEN FELDMAN, 1 GOVERNMENT CONTRACT AWARDS § 2:4 (2011) (corruption in negotiations in general); ERNST & YOUNG, GROWING BEYOND: A PLACE FOR INTEGRITY 19 (12th Global Fraud Survey 2012) (negotiations as leading to corruption in offset agreements).

⁴⁰ BRIAN LOUGHMAN AND RICHARD SIBERY, BRIBERY AND CORRUPTION: NAVIGATING THE GLOBAL RISKS 297 (2011); TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 19.

⁴¹ Seguin, *supra* note 36, at 9; ANDREW FEINSTEIN, THE SHADOW WORLD: INSIDE THE GLOBAL ARMS TRADE 291 (2011).

⁴² Seguin, *supra* note 36, at 24.

⁴³ LOUGHMAN AND SIBERY, *supra* note 40, at 297.

⁴⁴ Redlich and Miscavage, *supra* note 34, at 397, 398.

⁴⁵ The top seven countries that U.S. defense firms export to are Australia, Egypt, Israel, Japan, South Korea, United Arab Emirates, and the United Kingdom. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-952, DEFENSE EXPORTS: REPORTING ON EXPORTED ARTICLES AND SERVICES NEEDS TO BE IMPROVED 8 (2010) [hereinafter GOV'T ACCOUNTABILITY OFFICE, GAO-10-952]. Of these countries, Transparency International ranked Egypt as 112 out of 182 countries for the cleanliness of its government, and the Middle East was ranked as the

Finally, offsets are vulnerable to corruption because they often involve transactions unrelated to the work of the main defense sale. According to the Department of Commerce, 40 percent of offsets, as measured by value, are “direct” offsets; i.e., they relate directly to the defense article or service purchased.⁴⁶ Direct offsets usually require the manufacture of a weapon, or its components, in the purchaser’s country and are, as a result, concentrated in aerospace-related industries.⁴⁷ In contrast, 59 percent of offsets, as measured by value, are “indirect” offsets; i.e., they are unrelated to the defense article or service purchased.⁴⁸ Indirect offsets are diffused among a wide variety of industries such as motor vehicle parts, mining machinery, industrial chemicals, machine tools, wine and food products, and computer software.⁴⁹ The categorization of an offset as direct or indirect can be difficult, especially if it involves dual use technology, such as aerospace software, that may be applied to both the civilian and military sectors.⁵⁰ However, one European study estimated that 25 percent of European defense offset transactions are completely unrelated to the defense industry.⁵¹ This is supported by anecdotal evidence indicating that a significant number of offsets involve transactions with no connection to defense articles, services or technologies. For example, in the 1980s the sale of the F-18 to Spain involved indirect offsets that agreed to market Spanish exports, promote tourism, and provide other indirect offsets totaling \$1.3 billion.⁵² In the 1990s, Greek indirect

second-most corrupt region in the world after Sub-Saharan Africa. TRANSPARENCY INT’L, CORRUPTION PERCEPTIONS INDEX 2011 at 6-9 (2011) [hereinafter TRANSPARENCY INT’L, CORRUPTION PERCEPTIONS INDEX].

⁴⁶ DEP’T OF COMMERCE, SIXTEENTH STUDY, supra note 9, at 5, 27.

⁴⁷ *Foreign Military Sales and Offsets*, supra note 16, at 4; Ann Markusen, *Arms Trade As Illiberal Trade*, in *ARMS TRADE AND ECONOMIC DEVELOPMENT* 66, 75 (Jurgen Brauer and J. Paul Dunne eds., 2004).

⁴⁸ DEP’T OF COMMERCE, SIXTEENTH STUDY, supra note 9, at 5, 27.

⁴⁹ Markusen, supra note 47, at 75.

⁵⁰ Aris Georgopoulos, *Revisiting Offset Practices in European Defense Procurement: The European Defense Agency’s Code of Conduct on Offsets*, P.P.L.R. 2011, 1, 29-42, at 33 [hereinafter Georgopoulos, *Revisiting*].

⁵¹ Eriksson, supra note 33, at 3, 23.

⁵² *Foreign Military Sales and Offsets*, supra note 16, at 4.

offsets financed a corporation that invested in companies engaging in medical diagnostics, sportswear manufacture, financial services software, and other items unrelated to the defense industry.⁵³ Such deals prompt questions about whether these offset transactions serve any national interest for the purchasing governments, or whether they serve ulterior, improper purposes.

B. *Disparate Policy Goals*

Another reason that offsets are susceptible to corruption is their murky or confused policy goals. Purchasing governments use offsets to promote multiple national security and economic development interests; however, this combination of disparate policy goals can make it difficult to determine the purpose of a particular offset.⁵⁴ As a result, an offset's success can be difficult for outside parties to monitor and measure.⁵⁵

The primary justification for defense offsets is the mitigation of national security concerns that arise from the purchase of a foreign weapon system. When governments purchase foreign weapon systems, they do so because their domestic defense industries are incapable of manufacturing this weapon system on their own.⁵⁶ However, the

⁵³ *Concerns Over Offsets Generated Using U.S. Foreign Military Financing Program Funds: Hearing Before the H. Subcommittee on Commerce, Consumer Protection, and Competitiveness, Committee on Energy and Commerce, 112th Congress 4 (1994)* (statement of Frank C. Conahan, Assistant Comptroller General, National Security and International Affairs Division).

⁵⁴ Stefan Markowski and Peter Hall, *Mandatory Defense Offsets—Conceptual Foundations*, in *ARMS TRADE AND ECONOMIC DEVELOPMENT* 44, 45 (Jurgen Brauer and J. Paul Dunne eds., 2004) (lack of clarity in offset objectives).

⁵⁵ *Id.*

⁵⁶ BIALOS, *supra* note 29, at 79. The foreign sources a government may choose from are 1) purchases from a sole foreign vendor, or 2) purchases from a cooperative, multinational weapons development program, such as the European consortium that developed the Eurofighter Typhoon fighter jet. *Id.* at 79; Jay Edwards, *The EU Defence and Security Procurement Directive: A Step Towards Affordability?*, International Security Programme Paper ISP PP 2011/05, 6 (August 2011). In multinational arrangements, governments protect their security of supply interests through the principle of fair return on investment, or “juste retour,” which requires weapons programs to allocate the economic value of a project’s work to companies in proportion to the financial contributions that companies’ participating governments made to the program. Commission Green Paper on Defence Procurement, at 4, 9, COM (2004) 608 final (Sep. 23, 2004) [hereinafter Green Paper]; Baudouin Heuninckx, *A Primer To Collaborative Defence Procurement*

purchase of a foreign weapon system brings significant national security risks to the purchasing government. First, a purchasing government runs the risk that an external circumstance such as war, embargo, a shift in alliances, or a disruption to the supply chain could endanger its security of supply in a foreign weapon system.⁵⁷ Second, the purchase of a foreign weapon system could deprive a purchasing government of control over a technology which may also be acquired by an adversary.⁵⁸ To mitigate these risks, most purchasing governments require foreign vendors to provide offsets that will, for example, produce a specified number of weapon components within the purchasing country, or to transfer weapon technology to companies within the purchasing country.⁵⁹ Offsets, then, are a compromise between national security concerns and defense market realities: they allow a government to acquire a weapon beyond its domestic industry's capabilities, yet still retain some security of supply and technological control over the weapon.

However, offsets are not entered into solely for national security concerns; they also are done for political and economic reasons.⁶⁰ By mandating that work is sourced to domestic companies, direct offsets appease domestic defense industries and their workers

In Europe: Troubles, Achievements And Prospects, P.P.L.R. 2008, 3, 123-145, at 135. However, *juste retour* and the differing legal problems that it raises is beyond the scope of this thesis.

⁵⁷ Baudouin Heuinckx, *The EU Defence and Security Procurement Directive: Trick or Treat?*, P.P.L.R. 2011, 1, 9-28, at 22 [hereinafter Heuinckx, *Procurement Directive*].

⁵⁸ See BIALOS, *supra* note 29, at 5, 33 (governments traditionally procure defense items from domestic industry to promote technological superiority of their weapons systems).

⁵⁹ Green Paper, *supra* note 56, at 4-5 (offset requirements address security of supply and technological superiority concerns); U.S. GENERAL ACCOUNTING OFFICE, GAO-04-954T, DEFENSE TRADE:ISSUES CONCERNING THE USE OF OFFSETS IN INTERNATIONAL DEFENSE SALES 3 (2004) (offset requirements set by national laws or policies) [hereinafter GENERAL ACCOUNTING OFFICE, GAO-04-954T]; Markowski and Hall, *supra* note 54, at 45-46 (offsets use local content requirements to source a portion of the contract value in the buyer's territory); Markusen, *supra* note 47, at 68 (transfer of technology as typical in offset packages).

⁶⁰ Markusen, *supra* note 47, at 85; see also Taylor, *supra* note 28, at 31 (multiple objectives of offsets include technology transfer, supporting domestic industry, gaining access to new markets, generating exports, and forming alliances with multinational corporations).

by ensuring that some defense work is retained in country, despite the purchase of a foreign weapon system.⁶¹ Additionally, indirect offsets benefit domestic civilian industries by helping them develop new business through the introduction of fresh capital flows, new skills and technology, and new markets for products.⁶² Moreover, in all industries, offsets allow government officials to stimulate industrial development with increased government spending.⁶³ These economic development goals provide a separate, independent basis for the existence of offsets; however, they also make offsets more difficult to analyze.

Purchasing governments demand offsets to promote a mixed bag of economic and national security policies: at once, offsets promote the security of a nation's weapon supply, the technological capability of a nation's arsenal, the sustainment of its industrial base, and the development of new faculties in domestic industry.⁶⁴ As a whole, purchasing governments view their offsets as not only buying arms, but also as procuring a comprehensive bundle of goods and services that will enhance the welfare of their countries as a whole.⁶⁵ However, the multiple goals of offsets can make it difficult for outside parties such as academics, good government advocates and ordinary citizens to determine whether the goal of a particular offset is national security, economic

⁶¹ Dumas, supra note 15, at 25; Markowski and Hall, supra note 54, at 45-46.

⁶² Dumas, supra note 15, at 25.

⁶³ Markusen, supra note 47, at 80; Dumas, supra note 15, at 16.

⁶⁴ Heuinckx, *Procurement Directive*, supra note 57, at 22-23 (offsets as promoting security of supply); Georgopoulos, *Revisiting*, supra note 50, at 34 (offsets as assisting development of the European defense technological and industrial base); Taylor, supra note 28, at 31 (offsets as supporting key industries); Sandeep Verma, *Offset Contracts Under Defense Procurement Regulations In India: Evolution, Challenges and Prospects*, H.C.M. Rajasthan State Institute of Public Administration Occasional Paper No. 16, 1 (2009) (available at <http://ssrn.com/abstract=1464709>) (offsets as developing local capacities and channelizing investments to favored domestic sectors).

⁶⁵ Jurgen Brauer, *Economic Aspects Of Arms Trade Offsets*, in *ARMS TRADE AND ECONOMIC DEVELOPMENT* 54, 55 (Jurgen Brauer and J. Paul Dunne eds., 2004).

development, or a combination of the two.⁶⁶ Without clarity in the policy goal of an offset, it becomes difficult for outside parties to measure the offset's success, or even its legitimacy.⁶⁷

C. *Complex And Opaque Transactions*

Offsets are vulnerable to corruption because they combine a highly valuable economic asset with a lack of transparency.⁶⁸ Offsets, like defense procurements in general, lack transparency because their negotiation and award are shielded from public scrutiny due to alleged national security concerns.⁶⁹ Additionally, because offsets engage in unique, complex transactions and accounting practices, they are more difficult to monitor than regular defense sales.⁷⁰ As a result, it is difficult for non-offset specialists to monitor them, and this opacity and lack of accountability makes it easier for offset actors to exploit offsets for corruption.

Defense procurements are subject to secrecy due to their acquisition of items with high national security sensitivity, their containment of classified information, and their containment of protected commercial information.⁷¹ No government engaging in offsets

⁶⁶ Markowski and Hall, *supra* note 54, at 45 (lack of clarity in offset objectives).

⁶⁷ See *id.* (difficulty in measuring offset success).

⁶⁸ *Small Firm, Big Player*, DEFENSE NEWS, June 14, 2010, at 50.

⁶⁹ TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 14, 16.

⁷⁰ See Markowski and Hall, *supra* note 54, at 46 (offsets' use of countertrade, local content requirements, and bundled requirements); DoD 5105.38-M, SECURITY ASSISTANCE MANAGEMENT MANUAL, C.6.3.9.1 (October 3, 2003) (offset costs hidden in contract line items) [hereinafter DoD 5105.38-M].

⁷¹ See Directive 2009/81/EC, of the European Parliament and of the Council of 13 July 2009 on the Coordination of Procedures for the Award of Certain Works Contracts, Supply Contracts and Service Contracts by Contracting Authorities or Entities in the Fields of Defence and Security, and Amending Directives 2004/17/EC and 2004/18/EC, 2009 O.J. (L216) 80 at ¶27, 94 at Arts. 13(a) & 13(b) [hereinafter 2009 Directive] (exclusion of contract for intelligence activities, and contracts containing sensitive information, from the E.U. Defense Procurement Directive due to national security and confidentiality concerns); TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 14, 16 (opaque nature of defense procurement); FEINSTEIN, *supra* note 41, at 179 (review of offsets hindered by commercial confidentiality).

publishes the terms of individual offset arrangements to the public.⁷² Instead, governments publish broad trends about offsets.⁷³ As a result, data on offsets are scarce and monitoring them is difficult.⁷⁴ Moreover, the offset information that is actually reported is often difficult to decipher due to offset terminology, complex transactions, and cost accounting rules unique to offsets.

First, offsets engage in a complex web of transactions that use their own terminology. In general, these transactions fit into three categories: transfers of technology or financing, local content requirements, and countertrade.⁷⁵ Because an offset package will combine several types of these transactions in order to make a winning bid,⁷⁶ it is important to understand what these terms mean, and how they fit together.

Transfers of technology or financing (transfers) require a vendor to provide an additional product to a purchaser in order to win the main defense sale.⁷⁷ These additional products most often include the transfer of technology to a company domestic to the purchasing government;⁷⁸ the training of a domestic company on how to produce, maintain, or engineer a product;⁷⁹ or the lending of credit assistance to finance an offset

⁷² See Martin, *supra* note 6, at 15, 31 (details of individual offset projects not available in public databases).

⁷³ *Id.* at 33.

⁷⁴ *Id.*; Eriksson, *supra* note 33, at 3; BIALOS, *supra* note 29, at 96.

⁷⁵ Markowski and Hall, *supra* note 54, at 45-46.

⁷⁶ Markusen, *supra* note 47, at 68.

⁷⁷ Markowski and Hall, *supra* note 54, at 46.

⁷⁸ Technology transfer is a transfer of technology 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 defense vendor and offset recipient. DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 29.

⁷⁹ Training generally includes skills related to the production or maintenance of the exported defense item. Training may also be required in areas unrelated to the defense item, such as computer training, foreign language skills, or engineering capabilities. *Id.* at 29.

venture.⁸⁰ These transfers are vital to the success of an offset because they provide the technology, practical experience and financing to start up an offset arrangement.

However, because the provision of financing is rare in an offset deal, transfers usually consist of the provision of knowledge and skills to purchasing countries, such as when an offset in Oman required a vendor to sponsor a local air traffic control college.⁸¹ The most prevalent type of transfer—technology transfer—made up 18 percent, or \$10.4 billion, of the offset transactions of U.S. defense firms between 1993 and 2010.⁸²

A local content requirement mandates a vendor produce an agreed upon portion of the contract's value in the purchasing government's territory.⁸³ For example, a local content requirement may consist of a mandate for a domestic company to manufacture the landing gear for a fighter aircraft such as the F-16.⁸⁴ Within local content requirements, there are four types of trade: subcontracting,⁸⁵ licensed production,⁸⁶ co-production,⁸⁷ and investment.⁸⁸ The main distinction between these forms of local content is the transactional format used to package local production. Local content requirements are critical to an offset package because they are the portion of the offset arrangement that

⁸⁰ Credit assistance consists of direct loans, brokered loans, loan guarantees, assistance in achieving favorable payment terms, credit extensions, and lower interest rates. *Id.* at 27.

⁸¹ See *id.* at 21-23 (statistics for the provision of credit assistance in offsets); Ron Matthews, *Defense Offsets: Policy Versus Pragmatism*, in *ARMS TRADE AND ECONOMIC DEVELOPMENT* 89, 94 (Jurgen Brauer and J. Paul Dunne eds., 2004).

⁸² DEP'T OF COMMERCE, *SIXTEENTH STUDY*, *supra* note 9, at 22.

⁸³ Markowski and Hall, *supra* note 54, at 46.

⁸⁴ Markusen, *supra* note 47, at 73.

⁸⁵ Subcontracting is a direct commercial arrangement between the defense prime contractor and a foreign producer to make in the purchasing country a part or component of a US-origin defense article. DEP'T OF COMMERCE, *SIXTEENTH STUDY*, *supra* note 9, at 29.

⁸⁶ Licensed production is a transfer of technical information under direct commercial arrangements between a manufacturing vendor and a foreign government or producer, made in order to produce in the purchasing country a part or component of a US-origin defense article. *Id.* at 28.

⁸⁷ Co-production is a government-to-government agreement authorizing the transfer of technology to permit foreign companies to manufacture all or part of a US-origin defense article. Co-production is made pursuant to a Foreign Military Sale. *Id.* at 27.

⁸⁸ Investment is a dedication of capital to the establishment of a foreign entity unrelated to the defense sale, or to expanding the US firm's subsidiary or joint venture in the foreign country. *Id.* at 28.

requires direct or indirect offset products to be manufactured in the purchasing country. The most prevalent type of local content requirement—subcontracting—made up 21 percent, or \$11.9 billion, of the offset transactions of US defense firms between 1993 and 2010.⁸⁹

Countertrade is a reciprocal purchase of goods and services between a defense vendor and purchasing government.⁹⁰ Countertrade consists of three specialized types of trade: barter,⁹¹ counter-purchase,⁹² and buy-back.⁹³ A typical barter transaction requires a purchasing government to pay for defense items with raw materials, not currency, such as when the government of Malaysia paid for Russian MiG-29s with palm oil,⁹⁴ or when Iraq paid France for military supplies with oil.⁹⁵ A counter-purchase requires a vendor to market and sell manufactured material produced in the purchasing country, such as when a U.S. defense vendor marketed a Finnish company's papermaking machinery in the U.S.⁹⁶ Finally, the typical example of a buy-back is when a vendor agrees to invest in a physical plant in the purchasing country, and then agrees to buy back a certain portion of the output produced there.⁹⁷ Counter-purchase and buyback are key to an offset's success because they ensure that when a domestic company manufactures a new product,

⁸⁹ Id. at 22.

⁹⁰ Markowski and Hall, *supra* note 54, at 46.

⁹¹ Barter is a one-time transfer under a single contract that specifies the exchange of goods or services of equivalent value. Martin, *supra* note 6, at 32.

⁹² Counter-purchase is an agreement by the defense vendor to buy, or find a buyer for, a specified value of off-the-shelf items from the offset recipient. Id. at 32; DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 29.

⁹³ Buy-back is an agreement for the defense vendor to accept as full or partial repayment products that are derived from the original exported product. Martin, *supra* note 6, at 32.

⁹⁴ Redlich and Miscavage, *supra* note 34, at 390.

⁹⁵ Jean-Paul Hebert Interdisciplinary Research Center For Peace And Strategy Surveys-Paris, *Offsets And French Arms Exports*, in THE ECONOMICS OF OFFSETS: DEFENSE PROCUREMENT AND COUNTERTRADE 139, 141-142 (Stephen Martin, ed. 1996).

⁹⁶ Brauer, *supra* note 65, at 56-57.

⁹⁷ Id. at 55.

this domestic company will have assistance in finding a market for this new product. The most prevalent type of countertrade—counter-purchase—made up 36 percent, or \$20.6 billion, of the offset transactions of US defense firms between 1993 and 2010.⁹⁸

Second, in addition to offset terminology, offset accounting practices add an extra layer of complexity to offset transactions. These accounting practices affect both the selection and discharge phases of a procurement. During the selection phase, an offset proposal may be scored in terms of its cost, or an estimated value as determined by a formula created by the purchasing government.⁹⁹ During the discharge phase, an offset arrangement may be satisfied by a vendor earning a specified number of offset credits, and not strictly by performance.¹⁰⁰ This complexity in award and discharge is exacerbated by the fact that offset values and credits are sometimes calculated based on speculative, indefinite or arbitrary formulas, instead of a market price measured in currency.¹⁰¹ All of these practices are driven by five unique offset accounting practices.

The first accounting practice is that offset agreements specify the level of offset activity required by expressing it as a percentage of the sales contract's price.¹⁰² For

⁹⁸ DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 22.

⁹⁹ See THE UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, LEGAL GUIDE ON INTERNATIONAL COUNTERTRADE TRANSACTIONS 67-68, 71-72 (1993) (various methods for calculating the value of an offset [hereinafter UNCITRAL LEGAL GUIDE]); FEINSTEIN, *supra* note 41, at 177-178 (South African procurement which scored offset proposals based on their assessed value); Won-Joon Jang et al., *The Defense Offset Valuation Model*, THE DISAM JOURNAL, Dec. 2007, at 91, 92-93 (Korean government assessing technology offset proposals based on valuation models, as opposed to assessments based on cost).

¹⁰⁰ See GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 2 (offset credits as satisfying performance); Eriksson, *supra* note 33, at 30 (banked offset credits as satisfying performance); Barry Marvel, *The Reverse Piggyback Offset*, CONTRACT MANAGEMENT, Jul. 1, 2001 at 36 (banked offset credits as satisfying performance).

¹⁰¹ DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 27; UNCITRAL LEGAL GUIDE, *supra* note 99, at 71-72; see TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 17 (criticism of offset valuation criteria); Julia Muravska, Mark Pyman & Francisco Vilhena da Cunha, *Corruption Risks In Defense Offset Contracts 4* (Sep 9, 2010) (conference paper, Global Revolution V Conference) (available at <http://www.ti-defence.org/our-work/defence-corruption-risks-typology/procurement/offsets/>) (criticism of offset valuation criteria).

¹⁰² GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 2.

example, a purchasing government may require a beginning bid for a defense contract to contain at least 30 percent of its value as offset activity.¹⁰³ However, many countries require the value of an offset to be worth 100 percent or more of a defense sales contract's purchase price.¹⁰⁴

For an offset be worth more than the contract it is attached to, the second oddity of offset accounting must exist; namely, purchasing governments must use multipliers to grant additional offset credit to activities they wish to encourage.¹⁰⁵ A multiplier is a number that is compounded with the actual value of an offset transaction in order to calculate a higher or lower credit value.¹⁰⁶ A multiplier, for example, can increase an activity's credit value by a factor of two, 10, or even 30.¹⁰⁷ A procuring government's offset guidelines will state what multiplier it will assign to specific types of offset activity, such as direct subcontracting or technology transfer.¹⁰⁸ However, some offset policies allow government authorities to assign a range of multipliers to particular offset activity; for example, the value for a research and development proposal may be multiplied anywhere from 100 to 200 percent of its actual value in one Middle Eastern country, and may be multiplied by a factor of 10 to 30 in one European country.¹⁰⁹

The third accounting practice is that an offset's credit value at award may be based on cost, or it may be based on a formula devised by the purchaser.¹¹⁰ Valuing an offset at

¹⁰³ Id. at 27-28 (minimum offset percentage for Korean defense contracts above \$5 million in late 1980s).

¹⁰⁴ Eriksson, *supra* note 33, at 30; see also DEP'T OF COMMERCE, TWELFTH STUDY, *supra* note 33, at Appendix F.

¹⁰⁵ GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 2; GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 1; Matthews, *supra* note 81, at 98.

¹⁰⁶ DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 28.

¹⁰⁷ See DEP'T OF COMMERCE, TWELFTH STUDY, *supra* note 33, at Appendix F (offset multipliers used by Greece, the Netherlands, and Taiwan).

¹⁰⁸ Redlich and Miscavage, *supra* note 34, at 395-396.

¹⁰⁹ Id. at 395; DEP'T OF COMMERCE, TWELFTH STUDY, *supra* note 33, at Appendix F.

¹¹⁰ See Jang, *supra* note 99, at 91, 92-93 (description of technology valuation models to assess offset proposals, as opposed to assessments based on cost).

cost may be inappropriate because a defense vendor transferring its technology to a local company, for example, may demand that the purchasing government compensate it for estimated future royalties generated by the technology transfer.¹¹¹ However, valuation is a major weak point in offset agreements because market data may be unavailable for the subject of an offset, or because there may be imperfect data about the production abilities of a company receiving an offset award.¹¹² To value future royalties, governments fix a valuation in reference to projected production, sales or profits resulting from the technology which may, unfortunately, fail to materialize during performance.¹¹³ However, in more questionable valuation formulas, governments may resort to valuing an offset based on an analyst's assessment of the "credibility" of an offset proposal, or even the number of lines of code in software.¹¹⁴

The fourth practice in offsets is that in order to satisfy an offset obligation, a vendor must earn a specified number of offset credits, which are earned by engaging in activities listed in the offset agreement.¹¹⁵ For example, to earn the required number of offset credits, a vendor must sell a certain number of products in countertrade.¹¹⁶ To obtain discharge, a vendor must present its offset activity to an offset official within the

¹¹¹ See UNCITRAL LEGAL GUIDE, supra note 99, at 71-72.

¹¹² James C. Nobles, Jr. and Johannes Lang, *The UNCITRAL Legal Guide on International Countertrade Transactions: The Foundation for a New Era in Countertrade?*, 30 INT'L LAW 739, 749 (1996) (offset valuation as a weak point); GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, supra note 9, at 2 (lack of market data); Markowski and Hall, supra note 54, at 47, 49 (lack of market data, imperfect data on merits of a local contractor).

¹¹³ See UNCITRAL LEGAL GUIDE, supra note 99, at 72 (valuation methods for offset royalties); Markowski and Hall, supra note 54, at 49 (risk of default on offset obligations); Dumas, supra note 15, at 22 (risk of vendors shirking offset obligations or performing them in a perfunctory manner).

¹¹⁴ Jang, supra note 99, at 95, 96, 97-98.

¹¹⁵ GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, supra note 9, at 2.

¹¹⁶ Markowski and Hall, supra note 54, at 46.

purchasing government, who will determine whether the activity has earned the required number of offset credits.¹¹⁷

The final practice in offset accounting is that if a vendor engages in more offset activity than is required by the agreement, that vendor can “bank” the credit of this activity for use in satisfying future offsets, or for sale to other vendors having difficulty in satisfying their offsets.¹¹⁸ For example, if a vendor sells more products in countertrade than required by the offset agreement, it can store the value of these extra transactions as banked offset credits. Banked offset credits mitigate the risk of failing to perform an offset obligation because in lieu of default, a vendor may cash in its own banked credits or buy banked credits from another vendor to satisfy its offset obligation.¹¹⁹

The potential for these accounting practices to frustrate transparency, and invite corruption, is illustrated by one example. Specifically, in a South African offset arrangement connected to the purchase of German submarines, the offset requirement was in excess of 400 percent of the contract price.¹²⁰ It is unclear how an offset, which is supposed to recoup part of the purchase price,¹²¹ could be worth four times the value of the item being purchased. In fact, such an offset valuation seems outright meretricious. However, such is the current state of affairs in offset practice.

D. *Third Party Agents*

The hire of third party agents to develop and manage offset transactions is another factor making offsets vulnerable to corruption. Foreign agents and consultants are

¹¹⁷ GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, supra note 9, at 2.

¹¹⁸ Eriksson, supra note 33, at 30; Marvel, supra note 100, at 36; Verma, supra note 64, at 25.

¹¹⁹ Marvel, supra note 100, at 36.

¹²⁰ Matthews, supra note 81, at 98.

¹²¹ See Brauer and Dunne, supra note 12, at 3 (citing Bernard Udis and Keith E. Maskus, *Offsets As Industrial Policy: Lessons From Aerospace*, DEFENCE ECONOMICS, Vol. 2, No. 2, at 152 (1991) (offsets allow purchasing governments to recoup, or offset, some of their investment)).

generally considered to be the most common source of foreign bribery problems due to their involvement in more than 90 percent of reported FCPA cases.¹²² Because agents in the offset industry often have personal ties to high-ranking officials in their countries' defense ministries through prior military service or family connections, they are at risk of being compromised or having a conflict of interest.¹²³

To create and manage offset proposals, many defense vendors try to establish extensive offset operations in house.¹²⁴ The work of these in house operations is like that of a trading company, because they evaluate offset demands, market offset products, work with offset suppliers, trade banked offset credits, and perform a myriad of other services more similar to a venture capital firm's work than the work of a manufacturing company.¹²⁵ However, defense vendors employ in house operations mostly to work on direct offsets; for indirect offsets outside the vendor's area of expertise, vendors employ offset brokers to develop and deliver indirect offset projects.¹²⁶

An offset broker assists the defense vendor by developing multiple indirect offset proposals that correlate between a vendor's strengths and the needs of a purchasing country.¹²⁷ To develop these offset proposals, brokers employ think tanks consisting of high level ex-government, military, and industry leaders, as well as field representatives and proposal evaluators.¹²⁸ However, the potential political power of think tank

¹²² APCO International, Inc., FCPA Guide, <http://www.apcooilandgas.com/profiles/investor/fullpage.asp?BzID=1671&to=cp&Nav=0&LangID=1&s=0&ID=9892>, (last visited May 17, 2012); LOUGHMAN AND SIBERY, *supra* note 40, at 96. For a discussion of the FCPA, see *infra*, Section IV of this thesis.

¹²³ LOUGHMAN AND SIBERY, *supra* note 40, at 299; Interview with Lorraine L. Romero, Senior Counsel, General Law, Raytheon, in Arlington, VA (Mar. 8, 2012); Marvel, *supra* note 100, at 36.

¹²⁴ Markusen, *supra* note 47, at 71.

¹²⁵ *Id.* at 71, 77.

¹²⁶ *Id.* at 77; Redlich and Miscavage, *supra* note 34, at 393; Woolf Committee Report, *Business Ethics, Global Companies And The Defense Industry* 25, 28 (2008).

¹²⁷ Redlich and Miscavage, *supra* note 34, at 381, 385.

¹²⁸ *Id.* at 398.

members may create conflicts of interest that compromise a broker's offset proposals.¹²⁹ There is also a danger that brokers may place the pet projects of government officials into their proposals without properly vetting them.¹³⁰ Finally, because many brokers work on commission based on the successful award of sales contracts, these agents may be tempted to obtain contracts with the aid of corrupt payments, either with or without the knowledge of the prime contractor.¹³¹

An offset broker may also be in charge of executing the successful performance of an offset agreement.¹³² In such a capacity, offset brokers may purchase and resell offset goods like a trading company, or market offset goods for purchase by other parties.¹³³ In exchange for their services, brokers may charge a fee calculated as a fixed price per unit of goods sold, or as a percentage of the offset item's purchase price.¹³⁴ Because vendor compensation is based on commission, defense vendors must ensure their brokers provide adequate, legitimate documentation to substantiate every transaction.

Despite concerns about corruption perpetuated by offset agents, the burden of creating and satisfying offset proposals has become so substantial that there is now a niche in international marketing called a "reverse piggyback offset," which consists of a third party company proactively approaching multi-national corporations or governmental offset authorities with proposals to satisfy offset obligations.¹³⁵ Because these offset

¹²⁹ Marvel, *supra* note 100, at 36.

¹³⁰ Romero, *supra* note 123.

¹³¹ Woolf Committee Report, *supra* note 126, at 25, 28 (2008).

¹³² Redlich and Miscavage, *supra* note 34, at 381; Woolf Committee Report, *supra* note 126, at 28.

¹³³ UNCITRAL LEGAL GUIDE, *supra* note 99, at 78 (offset third parties acting as trading companies); Redlich and Miscavage, *supra* note 34, at 385 (offset brokers as marketers for a targeted country).

¹³⁴ UNCITRAL LEGAL GUIDE, *supra* note 99, at 85.

¹³⁵ Marvel, *supra* note 100, at 36. The "reverse" term refers to the broker seeking out the multi-national corporation with an offset proposal, versus the corporation hiring the broker to then develop a proposal. The "piggyback" term refers to the broker piggybacking its own offset project onto the corporation's sponsorship into a foreign market.

proposals do not originate with the defense vendor or its agents, reverse piggyback offsets amplify the risks posed by offset third parties even further. However, the pressure, or even desperation, to create and fulfill offset proposals has made it possible for such risky business arrangements to exist.¹³⁶

III. MAJOR INTERNATIONAL OFFSET REGULATIONS

Although international trade in defense offsets generates billions of dollars in revenue, a remarkable aspect of offset trade is how lightly it is regulated.¹³⁷ Offsets in defense procurements face no substantial regulation by the WTO, which leaves purchasing and exporting countries with a free hand in how to regulate their countries' offset practices. This has led to a divide on how to regulate offsets, with the E.U. attempting to restrict their use, and the U.S. leaving them largely unregulated.

A. *Agreement On Government Procurement*

In general, the WTO's Agreement on Government Procurement (GPA)¹³⁸ expressly prohibits acceding countries from imposing, seeking or considering offsets.¹³⁹ However, the GPA's general prohibition on offsets does not stop GPA members from demanding

¹³⁶ See Markusen, *supra* note 47, at 77 (vendors buying offset credits in the market from brokers).

¹³⁷ GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 2 (offsets unregulated in U.S.); Eriksson, *supra* note 33, at 29 (offsets regulated by only half of members of E.U., and existing regulations in some countries are non-binding); DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 4 (offsets entered into by U.S. companies generating \$56 billion in trade between 1993 and 2010).

¹³⁸ Revision of the Text of the 1994 Agreement on Government Procurement, Marrakesh Agreement Establishing the World Trade Organization, Annex 4, (Dec. 15, 2011) (hereinafter GPA). The GPA establishes an international framework of rights and obligations regarding government procurement. The cornerstone principles of the GPA are non-discrimination and transparency in government procurement among its Member States. Because the GPA is a "plurilateral" agreement, only WTO members who are signatories to the GPA are bound by its terms. See http://www.wto.org/english/tratop_e/gproc_e/gpa_overview_e.htm.

¹³⁹ GPA, *supra* note 138, at art. XVI(1).

offsets in their defense procurements.¹⁴⁰ This dissonance in offset practice is able to occur because the GPA's anti-offset provision is made inapplicable to defense procurements through two loopholes in the GPA.

First, Article XXIII of the GPA states its terms do not apply to procurements for "arms, ammunition or war materials" or to procurements "indispensable for national security" if the acceding nation considers this procurement "necessary for the protection of its essential security interests."¹⁴¹ Armament procurements are historically some of the most protected markets in a nation, and that is reflected by their exclusion from the rules of the GPA.¹⁴²

Second, the GPA covers a defense ministry's procurement of non-armament items only if a country has negotiated an inclusion for them, as reflected in that country's individual annex to the GPA.¹⁴³ The terms of a country's annex can exclude GPA coverage of a defense ministry purchase if the purchase falls below a certain dollar threshold, or if the purchase is made by an agency within the defense ministry that is explicitly excluded from GPA coverage.¹⁴⁴ Additionally, a defense ministry purchase can be excluded if the terms of a country's annex state that a defense ministry purchase is covered only if the subject of the purchase is specifically included on a list in the annex,

¹⁴⁰ For example, although the E.U. is a member of the GPA, many E.U. Member States still have laws or policies requiring offsets for their defense procurements. *Id.* at E.U. Annex 1 (E.U. membership in the GPA); Eriksson, *supra* note 33, at 4 (offset policies of a sample of E.U. Member States).

¹⁴¹ GPA, *supra* note 138, at art. XXIII(1).

¹⁴² See BIALOS, *supra* note 29, at 1 (historical protectionism in defense markets).

¹⁴³ In the U.S. Annex to the GPA, for example, multiple types of purchases are explicitly excluded from GPA coverage. GPA, *supra* note 138, at U.S. Annex 1.

¹⁴⁴ Arie Reich, *The New Text of the Agreement on Government Procurement: An Analysis and Assessment*, 12 J. INT'L ECON. L. 989, 992 (2009).

and a country deliberately fails to list certain types of goods or services in its defense ministry coverage.¹⁴⁵

States acceding to the GPA routinely use gaps in GPA coverage of defense procurements to exempt their defense offsets from GPA scrutiny. For example, a defense procurement for aircraft may require an indirect offset for the manufacture of auto parts.¹⁴⁶ The GPA's lack of coverage over this offset exists because, first, the offset is being purchased by a defense ministry pursuant to an armament procurement.¹⁴⁷ Second, the subject of an offset, by design, is not listed as a covered defense ministry item in that country's Annex to the GPA. Going back to the auto parts example, such an offset has been required by the government of Japan, yet the Japanese Annex to the GPA noticeably does not include any type of automotive product in its defense ministry's coverage.¹⁴⁸ As a result of these coverage issues, the GPA's exemption for defense procurements extends to defense offsets.

B. European Union Regulations

Like the WTO, the E.U. disfavors offsets and has initiated two recent efforts to curb their use: a voluntary Code of Conduct on Offsets, and an E.U. Defense Procurement Directive. However, also like the WTO, the E.U.'s efforts do not effectively regulate defense offsets.

E.U. Member States control their own defense procurements, and as a result the purchase of defense items in the Community has been historically fragmented along

¹⁴⁵ *Id.* at 992.

¹⁴⁶ Markusen, *supra* note 47, at 76 (auto parts offsets in Japan).

¹⁴⁷ Although an offset may be managed in some countries by a separate ministry, the purchase of the offset itself is done through the defense ministry. See Marvel, *supra* note 100, at 36.

¹⁴⁸ GPA, *supra* note 138, at Japan Annex 1; Markusen, *supra* note 47, at 76 (auto parts offsets in Japan).

national lines.¹⁴⁹ Similarly, the E.U.'s rules on offsets are also fragmented, with about half of the Member States requiring offsets through binding laws, presidential decrees, or ministerial regulations.¹⁵⁰ Despite the presence of these national offset laws, a study commissioned by the European Defence Agency (EDA) was not in favor of defense offsets, concluding they violated the free movement of goods and services required by the European Community Treaty.¹⁵¹ However, because of the politically sensitive nature of offsets, the E.U. has not outright banned them.¹⁵²

Instead of banning offsets, in 2011 the E.U. promulgated a voluntary Code of Conduct which states basic principles that should be followed in offset agreements.¹⁵³ These principles include clearly stipulating offset requirements in contract notices, minimizing the weight of offsets as award criteria, and not having offset valuation exceed the value of the procurement contract.¹⁵⁴ The goal of these principles is to mitigate the adverse effects of offsets.¹⁵⁵ Even though the Code of Conduct has been subscribed to by every Member State participating in the EDA (except Romania), it is unlikely that the Code of Conduct has appreciably affected Community offset practices because the Code of Conduct has no enforcement mechanism.¹⁵⁶

¹⁴⁹ Stacy N. Ferraro, *The European Defence Agency: Facilitating Defense Reform or Forming Fortress Europe?*, 16 *TRANSNAT'L L. & CONTEMP. PROBS.* 549, 555 (2007); Green Paper, *supra* note 56, at 4.

¹⁵⁰ Eriksson, *supra* note 33, at 29.

¹⁵¹ *Id.* at 25; Georgopoulos, *Revisiting*, *supra* note 50, at 31.

¹⁵² Georgopoulos, *Revisiting*, *supra* note 50, at 30, 31.

¹⁵³ A Code of Conduct on Offsets Agreed by the EU Member States Participating in the European Defence Agency 1 (May 3, 2011), eda.europa.eu/Otheractivities/COCOOffsets.

¹⁵⁴ *Id.* at 3-4.

¹⁵⁵ *Id.* at 1.

¹⁵⁶ See Georgopoulos, *Revisiting*, *supra* note 50, at 32 (lack of enforcement mechanism in Code of Conduct on Offsets).

The second E.U. effort to restrict offsets is the 2009 defense procurement regulation, Directive 2009/81/EC, which seeks to make a Europe-wide defense equipment market.¹⁵⁷ Like the GPA, the general rule of the Directive is that contracting authorities must treat all bidders for defense procurements in a non-discriminatory manner.¹⁵⁸ This prohibition on discrimination probably includes discrimination through defense offsets, even though offsets are not mentioned in the Directive.¹⁵⁹ However, the Directive's terms do not restrict offset practice in a meaningful way. The Directive's rules apply to procurements for all military equipment; i.e., "equipment specifically designed or adapted for military purposes and intended for use as an arm, munitions or war material."¹⁶⁰ Yet the problem with the Directive is that it includes several exceptions to its coverage: the Directive does not cover procurements done in cooperative development programs;¹⁶¹ international agreements or arrangements, such as a Memorandum of Understanding (MOU);¹⁶² and government-to-government contracts.¹⁶³ These exceptions swallow the Directive's rule against non-discrimination in defense procurement, because they exclude all the procurement mechanisms the Community is currently using, for example, to procure its aircraft. Specifically, E.U. Member States used collaborative procurement for the Eurofighter Typhoon,¹⁶⁴ an MOU for the F-35,¹⁶⁵ and a government-to-government sale

¹⁵⁷ 2009 Directive, supra note 71, at 76.

¹⁵⁸ GPA, supra note 138, at art. III; 2009 Directive, supra note 71, at 92.

¹⁵⁹ Heuninckx, *Procurement Directive*, supra note 57, at 25-26.

¹⁶⁰ 2009 Directive, supra note 71, at 90-91.

¹⁶¹ *Id.* at art. 13(c), 2009 O.J. (L216) 76, 94.

¹⁶² *Id.* at art. 12, 2009 O.J. (L216) 76, 94; Christopher R. Yukins, Feature Comment, The European Defense Procurement Directive: An American Perspective, 51 *GOV'T CONTRACTOR* ¶ 383, Nov. 4, 2009, at 6.

¹⁶³ 2009 Directive, supra note 71, at 94.

¹⁶⁴ Edwards, supra note 56, at 6.

¹⁶⁵ Michele Nones et al., *Europe And The F-35 Joint Strike Fighter (JSF) Program*, Quaderni IAI, 8-9 (2009); U.S. GENERAL ACCOUNTING OFFICE, GAO-03-775, JOINT STRIKE FIGHTER ACQUISITION: COOPERATIVE PROGRAM NEEDS GREATER OVERSIGHT TO ENSURE GOALS ARE MET 1 (2003) [hereinafter GENERAL ACCOUNTING OFFICE, GAO-03-775].

for the F-16.¹⁶⁶ As a result, the E.U.’s Directive does not restrict the use of offsets in the excepted procurement mechanisms, and does not achieve a regulation that polices offsets in a meaningful way.

C. United States Regulations

In contrast to the E.U.’s approach toward offsets, the U.S. government has declared a “hands off” approach that does not attempt to directly regulate them.¹⁶⁷ Although the U.S. government views offsets as economically inefficient and market distorting, the U.S. maintains that the decision on whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved.¹⁶⁸ Moreover, the U.S. will not intervene on a contractor’s behalf to ensure an offset obligation is satisfied.¹⁶⁹ However, the U.S. does maintain some indirect control over offset agreements entered into by U.S. companies.¹⁷⁰ Specifically, the U.S. restricts offsets through its rules for Direct Commercial Sales (DCS) and Foreign Military Sales (FMS). However, the restrictions the U.S. government places on offsets through the DCS and FMS programs are very broad and unsophisticated.

When a U.S. vendor sells defense articles, services or technical data to a foreign government, it must do so through the DCS or FMS programs.¹⁷¹ DCS is a commercial

¹⁶⁶ Seguin, *supra* note 36, at 11.

¹⁶⁷ U.S. GENERAL ACCOUNTING OFFICE, GAO/NSIAD-93-13, *MILITARY EXPORTS: RECENT IMPLEMENTATION OF OFFSET LEGISLATION 4* (1990); GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 2.

¹⁶⁸ Defense Production Act Amendments of 1992 (Pub. L. 102-558, Title I, Part C, § 123, 106 Stat. 4198).

¹⁶⁹ See Udis and Maskus, *supra* note 17, at 359-360 (refusal of U.S. government to intervene with a foreign government to satisfy an offset obligation after 1978).

¹⁷⁰ An additional U.S. statutory control of offsets is the Feingold Amendment, which prohibits vendors and their agents from making incentive payments for the satisfaction of offset obligations. 22 U.S.C. § 2779a (2010). For a discussion of the politics behind the creation of this amendment, see Udis and Maskus, *supra* note 17, at 366-367.

¹⁷¹ THE DEFENSE INSTITUTE OF SECURITY ASSISTANCE MANAGEMENT, *THE MANAGEMENT OF SECURITY ASSISTANCE 1-2, 1-6, 15-1* (27TH ED. 2007) [hereinafter *DISAM*].

export to a foreign government, and is authorized under the Arms Export Control Act.¹⁷² Before export, a defense vendor must obtain an export license from the State Department per the International Traffic in Arms Regulations.¹⁷³ A DCS procurement is negotiated directly between a defense vendor and purchasing government, and offset provisions may be part of the main contract for the defense item or a separate agreement.¹⁷⁴ However, the U.S. exerts control over an offset by not granting an export license for technology requested by a purchasing government. For example, the U.S. did not grant an export license for Lockheed Martin to sell the F-35 to India in 2011.¹⁷⁵ As a result, around 85 percent of offset obligations are satisfied with mature technologies that are at least 10 years old.¹⁷⁶

FMS is a government-to-government agreement where the Department of Defense (DOD) sells arms to foreign governments.¹⁷⁷ Under the FMS program, a defense vendor does not sell defense items directly to the purchasing government and does not obtain an export license.¹⁷⁸ Instead, the purchasing government enters into a contract with the U.S. government where the U.S. government agrees to sell the foreign government the defense item; in turn, the U.S. government then contracts separately with the defense vendor under the Federal Acquisition Regulation (FAR) to purchase the defense item for the

¹⁷² *Id.* at 1-6. For the general criteria a defense export must meet to obtain an export license, see the Arms Export Control Act, 22 U.S.C. § 2753.

¹⁷³ 22 C.F.R. § 127.1(a); DISAM, *supra* note 171, at 15-2.

¹⁷⁴ DISAM, *supra* note 171, at 15-2.

¹⁷⁵ See Lamont and Boxell, *supra* note 26, at (inability of India to purchase a fifth-generation fighter aircraft, such as the F-35).

¹⁷⁶ DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 14; Matthews, *supra* note 81, at 99 (85 percent of U.S. offsets satisfied with technology that is over 10 years old).

¹⁷⁷ *United States ex. rel. Campbell v. Lockheed Martin Corp.*, 282 F.Supp.2d 1324, 1327 (D.C.M.D. 2003); DISAM, *supra* note 171, at 1-2; See DFARS § 225.7300-7307 for FAR regulations pertaining to FMS.

¹⁷⁸ 22 C.F.R. § 126.6; DISAM, *supra* note 171, at 1-2.

foreign government.¹⁷⁹ The vendor sells the defense item to the U.S. government, which then resells them to the foreign government.¹⁸⁰ As a result of this multi-step procurement process, there is no privity of contract between the vendor and purchasing government.¹⁸¹

Offsets become part of an FMS export because a purchasing government will first conduct its own procurement competition among several nations' vendors. Next, a U.S. vendor will submit an offset proposal as part of its bid, the purchasing government will pick the U.S. vendor's bid, and then the purchasing government will approach the U.S. government to request a sole-source FMS award to its chosen U.S. vendor.¹⁸²

The procurement of the defense item will occur through a contract between the U.S. government and the purchasing government called a Letter of Offer and Acceptance (LOA), but the offset agreement will occur in a separate agreement between the defense vendor and the purchasing government.¹⁸³ This curious offset arrangement exists because of the U.S. government's policy to not be a party to offset agreements.¹⁸⁴ However, the defense vendor recovers its offset costs under the offset agreement by increasing the LOA's sales price.¹⁸⁵ Specifically, the vendor increases the line item unit

¹⁷⁹ *Campbell*, supra note 177, at 1327.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 1341. Privity of contract exists when there is a contractual relationship between parties. In order to maintain an action to recover for breach of contract, privity must exist between the party damaged and the party sought to be held liable. See *Norris v. Housing Authority of the City of Galveston*, 980 F.Supp. 885, 892 (S.D. Tex. 1997).

¹⁸² See DISAM, supra note 171, at 9-7 (availability of sole-source FMS due to a purchasing government's competition); FAR § 6.302-4 (sole source selection by U.S. government allowed when acquisition will be reimbursed by a foreign country through a Letter of Offer and Acceptance); Redlich and Miscavage, supra note 34, at 393 (defense item, price and offset package as the three parts of a defense vendor's bid to a purchasing government).

¹⁸³ DISAM, supra note 171, at 9-7, 9-19 to 9-20.

¹⁸⁴ *Id.* at 9-19 to 9-20; DFARS § 225.7306.

¹⁸⁵ DISAM, supra note 171, at 9-19 to 9-20; FAR § 225.7303-2(A)(3); DoD 5105.38-M, supra note 70, at C6.3.9.1.

price of the defense item to cover offset costs.¹⁸⁶ As a result, the defense vendor bills the U.S. government for the costs of the defense item as well as the costs of the offset, and the U.S. government recovers these costs through its resale to the purchasing government.¹⁸⁷

The U.S. government's regulations on offsets in FMS are indirect and broad; nevertheless, they place some restraint on subcontracting and accounting practices in FMS offset agreements. First, a DOD contracting officer will honor a purchasing government's request to place a subcontract with a particular firm only if there is full and open competition, or if the LOA specifically requires a product to be obtained from this firm.¹⁸⁸ This provision would also apply to a sole source award for a direct offset subcontract.¹⁸⁹ In order to justify a sole source request in the LOA, a purchasing government must provide a written rationale to U.S. contracting authorities demonstrating how the sole source is based on the objective needs of the purchasing government, and how the exclusion of other sources is not arbitrary, capricious or discriminatory.¹⁹⁰ Second, because DOD assumes responsibility to see a fair price is paid for an FMS acquisition, a DOD contracting officer must determine whether a vendor's offset costs are reasonable and allocable, as with any other element of contract cost.¹⁹¹

¹⁸⁶ DISAM, supra note 171, at 9-19 to 9-20; DoD 5105.38-M, supra note 70, at C6.3.9.1.

¹⁸⁷ See DISAM, supra note 171, at 9-20 (U.S. government is the "banker" for offset transactions).

¹⁸⁸ DFARS § 225.7304(a); FAR § 6.302-4. "Full and open competition" is when all responsible sources are permitted to compete in a contract action. FAR § 2.101.

¹⁸⁹ Interview with Charles Blair, Branch Chief, Aviation Procurement Law Section, Army Aviation Life Cycle Management Command, U.S. Department of the Army (Feb. 24, 2012). A sole source acquisition is a contract that is entered into by an agency after soliciting and negotiating with only one source. FAR § 2.101.

¹⁹⁰ DoD 5105.38-M, supra note 70, at C6.3.4; ANTHONY J. PERFILO, FOREIGN MILITARY SALES HANDBOOK § 6:13 (2010).

¹⁹¹ PERFILO, supra note 190, at §§ 5:3, 5:27. Under the FAR, a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of

Such a determination is usually made by a contract officer's review of an offset's projected labor, material and overhead costs.¹⁹² The contracting officer's review, while far from perfect, gives some deterrent to inflating prices in offset agreements in order to recoup the costs of corrupt activity. However, on the whole, U.S. offset regulations put no restrictions on offset practice, but only broad oversight of offset administration.

IV. MAJOR INTERNATIONAL ANTI-CORRUPTION OFFENSES

Although there is no effective regulation of offsets internationally, there are several statutes in multiple jurisdictions which punish vendor's corrupt conduct in an offset agreement. The most prominent international anti-corruption laws are the Foreign Corrupt Practices Act (FCPA),¹⁹³ the U.K. Bribery Act of 2010 (Bribery Act),¹⁹⁴ and the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (Anti-Bribery Convention) by the OECD.¹⁹⁵ These laws take different approaches at regulating international corruption, but when their disparate provisions are combined together, they create four offenses that may punish corruption in a defense offset: bribery of a foreign official,¹⁹⁶ commercial bribery,¹⁹⁷ recordkeeping and internal control violations,¹⁹⁸ and failure of a commercial organization to prevent bribery.¹⁹⁹ In

competitive business. FAR § 31.201-3. A cost is allocable if it is assignable or chargeable to a contract. FAR § 31.201-4.

¹⁹² Blair, *supra* note 189; but see PERFILO, *supra* note 190, at § 5:27 (2010) (contracting officer not having much visibility over offset costs in a competed FMS contract).

¹⁹³ 15 U.S.C. §§ 78dd-1 – 78ff, 78m (1998).

¹⁹⁴ Bribery Act, 2010, c.23 (U.K.).

¹⁹⁵ Organization for Economic Co-operation and Development, Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, Nov. 21, 1997, 37 I.L.M. 1, art. 1 [hereinafter OECD Anti-Bribery Convention].

¹⁹⁶ 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a) (1998) (bribery of foreign officials prohibited by securities issuers, domestic concerns, and persons other than issuers or domestic concerns); Bribery Act, 2010, c.23, § 6 (U.K.) (bribery of a foreign public official); OECD Anti-Bribery Convention, *supra* note 195, at art. 1 (bribery of a foreign public official).

¹⁹⁷ Bribery Act, 2010, c.23, § 1 (U.K.) (bribing another person).

¹⁹⁸ 15 U.S.C. § 78m (1998).

addition, because approximately 40 percent of U.S. defense export sales (and their accompanying offsets) occur through FMS,²⁰⁰ U.S. defense vendors face liability under the False Claims Act²⁰¹ and the FAR²⁰² for corrupt offset transactions. A basic understanding of all these conventions, statutes and regulations is necessary to appreciate the liability risks faced by a defense vendor for a corrupt offset transaction.

A. *Bribery Of A Foreign Official*

The FCPA, Bribery Act and Anti-Bribery Convention each prohibit individuals and corporations from bribing a foreign official.²⁰³ Although these laws generally track with each other in most of their elements,²⁰⁴ each uses different phraseology and approaches.²⁰⁵ More importantly, all three laws create flexible frameworks for punishing the bribery of a foreign official, no matter what mechanism a party uses to transfer the bribe, so offset vendors must be vigilant in complying with their provisions.

The general principles that criminalize the bribery of foreign officials are created by the Anti-Bribery Convention, which is an international agreement that requires signatory countries to enact laws that implement its provisions criminalizing the bribery of foreign

¹⁹⁹ Bribery Act, 2010, c.23, § 7 (U.K.).

²⁰⁰ GOV'T ACCOUNTABILITY OFFICE, GAO-10-952, supra note 45, at 6-7.

²⁰¹ 31 U.S.C. §§ 3729-3733 (2009).

²⁰² DFARS § 201.104 (applicability of FAR to FMS); FAR § 52.203-13(b) (FAR ethics program and mandatory disclosure rules); FAR § 3.1003 (suspension or debarment for failure to follow FAR mandatory disclosure rule).

²⁰³ 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a) (1998) (bribery of foreign officials prohibited by securities issuers, domestic concerns, and persons other than issuers or domestic concerns); Bribery Act, 2010, c.23, § 6 (U.K.) (bribery of a foreign public official); OECD Anti-Bribery Convention, supra note 195, at art. 1.

²⁰⁴ LOUGHMAN AND SIBERY, supra note 40, at 12; F. Joseph Warin et al, *The British Are Coming!: Britain Changes Its Law on Foreign Bribery and Joins the International Fight Against Corruption*, 46 TEX. INT'L L.J. 1, 15 (2010).

²⁰⁵ See 15 U.S.C. §§ 78dd-1(a), -2(a), -3(a); Bribery Act, 2010, c.23, § 6 (U.K.). The OECD does not require uniformity of language among countries statutes, but only functional equivalence. Organization for Economic Co-operation and Development, Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and Related Documents 14 (2011) [hereinafter OECD Related Documents].

officials.²⁰⁶ The Anti-Bribery Convention entered into force in 1999, and by 2012 it had been signed and ratified by 39 countries.²⁰⁷ The Anti-Bribery Convention makes it illegal for any person to offer, promise or give an undue payment to a foreign public official in order to obtain or retain business, or to receive any other improper advantage.²⁰⁸ A payment is undue if it is made intentionally, and is done in order to have the foreign official act or refrain from acting in relation to the performance of their official duties.²⁰⁹ Obtaining or retaining business occurs if a party obtains a government contract, and an improper advantage exists if a party makes a payment to receive

²⁰⁶ OECD Anti-Bribery Convention, 37 I.L.M. 1, preamble, art. 1; Organization for Economic Cooperation and Development, OECD Anti-Bribery Convention: Entry into Force of the Convention, http://www.oecd.org/document/12/0,3746,en_2649_34859_2057484_1_1_1_1,00.html (last visited July 18, 2012) [hereinafter OECD Entry Into Force].

²⁰⁷ OECD Anti-Bribery Convention, 37 I.L.M. 1, preamble; OECD Entry Into Force, supra note 206. The 39 countries are Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Russian Federation, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States. OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions: Ratification Status as of April 2012, <http://www.oecd.org/dataoecd/59/13/40272933.pdf> (last visited July 21, 2012).

²⁰⁸ OECD Anti-Bribery Convention, supra note 195, at art. 1. The phraseology for who is a foreign public official differs among the Anti-Bribery Convention, FCPA, and Bribery Act. Under the Anti-Bribery Convention, a foreign public official is “any person holding a legislative, administrative or judicial office of a foreign country, whether appointed or elected; any person exercising a public function for a foreign country, including for a public agency or public enterprise; and any official or agent of a public international organization.” Id. at art. 1(4). The Bribery Act largely adheres to this definition, varying only by making reference to countries or territories outside the United Kingdom. Bribery Act, 2010, c.23, § 6(5) (U.K.). However, under the FCPA, a foreign official is “any officer or employee of a foreign government or any department, agency or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization.” 15 U.S.C. §§ 78dd-1(f)(1), -2(h)(2), -3(f)(2).

²⁰⁹ OECD Anti-Bribery Convention, 37 I.L.M. 1, preamble, art. 1. Under the FCPA, a party must act with corrupt intent. 15 U.S.C. §§ 78dd-1(a), -2(a), -3(a). Although the FCPA does not define corrupt intent, courts interpreting this element have stated an act is with corrupt intent if done willfully, voluntarily, intentionally, and with a bad purpose of accomplishing either an unlawful end or result, or a lawful end or result by some unlawful method or means. *U.S. v. Liebo*, 923 F.2d 1308, 1312 (8th Cir. 1991); *U.S. v. Kay* (Kay III), 513 F.3d 461, 464 (5th Cir. 2007). The Bribery Act and Anti-Bribery Convention do not require corrupt intent; this was done in order to forestall any defenses alleging cultural norms or expectations made a questionable payment legitimate. Warin, supra note 204, at 16; see also Bribery Act, 2010, c.23, § 6 (U.K.); OECD Anti-Bribery Convention, Nov. 21, 1997, 37 I.L.M. 1, art. 1 (lack of reference to corrupt intent).

something it is not clearly entitled to, such as a permit.²¹⁰ An illegal payment may be made either to a foreign official or another person or entity affiliated with the official, such as a family member or business.²¹¹ Likewise, liability for the bribing party exists for payments that it makes directly, as well as for payments made indirectly through intermediaries.²¹²

The criminal penalties for bribing a foreign official are significant. Under the FCPA, individuals may be imprisoned up to 5 years and fined twice the pecuniary gain from the bribe, twice the victim's loss, or \$100,000.²¹³ Businesses may be fined twice the pecuniary gain, twice the victim's loss, or \$2,000,000.²¹⁴ In practice, a fine of twice the pecuniary gain or loss may result in nine-figure fines that far exceed the statutory maximums.²¹⁵ Similarly, the Bribery Act provides for fines to individuals and businesses, as well as 10 years imprisonment.²¹⁶

For a defense vendor, the provisions of the Anti-Bribery Convention, FCPA and Bribery Act pose three especially pressing problems. First, these laws' punishment of indirect payments make defense vendors liable for illegal payments made by the vendor's sales or marketing agents, consultants, and joint venture partners.²¹⁷ Second, the definition of an improper purpose is broad enough to encompass bribery for the award of

²¹⁰ OECD Related Documents, *supra* note 205, at 14.

²¹¹ OECD Related Documents at 14. For FCPA liability for payments made to entities owned or affiliated with government officials, see ROBERT W. TARUN, *THE FOREIGN CORRUPT PRACTICES ACT HANDBOOK 7* (2nd ed. 2012). For Bribery Act liability, see Ministry of Justice, *The Bribery Act of 2010—Guidance*, 2011, at 12-13 (U.K.).

²¹² OECD Anti-Bribery Convention, 37 I.L.M. 1, art. 1; see also 15 U.S.C. §§ 78dd-1(a), -2(a), -3(a); Bribery Act, 2010, c.23, § 6 (U.K.) (liability for indirect payments through intermediaries).

²¹³ 15 U.S.C. § 78dd-2(g)(2); 18 U.S.C. § 3571(d).

²¹⁴ 15 U.S.C. §§ 78dd-2(g)(1), 78ff(c); 18 U.S.C. § 3571(d).

²¹⁵ TARUN, *supra* note 211, at 19.

²¹⁶ Bribery Act, 2010, c.23, § 11 (U.K.).

²¹⁷ OECD Related Documents at 14; TARUN, *supra* note 211, at 7; Ministry of Justice, *supra* note 211, at 12-13.

offset credit. Because offset credit relieves a defense vendor of financial liability to a purchasing government,²¹⁸ the improper award of such credit would probably be sufficient to create an improper advantage for a bribing party. Finally, a “foreign official” may include not only employees of traditional foreign government agencies, but also employees of a state-owned or state-controlled entity.²¹⁹ Because offsets in Europe are frequently granted to state-owned defense contractors,²²⁰ liability for bribes to state-owned enterprise employees would immediately impact offset practitioners, expanding the scope of conduct they are at risk of being liable for.

B. *Commercial Bribery*

Another prohibition that multinational companies must address is the risk of commercial bribery in international transactions.²²¹ The Bribery Act prohibits commercial bribery in cases where a financial advantage induces or rewards private persons for improperly performing functions in the scope of their employment or business.²²² Before the enactment of the Bribery Act, the Department of Justice (DOJ) was able to prosecute commercial bribery under the Travel Act if a bribing party used interstate travel or commerce to distribute the proceeds of bribery, or under the Federal Wire Fraud Act if a bribing party used transmissions in interstate commerce to promote a fraudulent scheme.²²³ Although such prosecutions have so far been rare,²²⁴ defense

²¹⁸ GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, supra note 9, at 2.

²¹⁹ Liability under the FCPA for a bribe to an employee of a state-owned enterprise is currently being litigated; however, so far courts have denied defense motions to dismiss prosecutions based on bribes to state-owned entities, deciding that the definition of a foreign official is a question of fact. *U.S. v. Aguilar*, 783 F.Supp.2d 1108, 1115, 1120 (C.D.C.A. 2011).

²²⁰ Georgopoulos, *Revisiting*, supra note 50, at 36.

²²¹ Warin, supra note 204, at 43.

²²² Bribery Act, 2010, c.23, § 6 (U.K.).

²²³ 18 U.S.C. § 1952 (2002); 18 U.S.C. § 1343 (2008).

vendors are at risk for being prosecuted under the Bribery Act, Travel Act or Federal Wire Fraud Act if, for example, a defense vendor paid a subcontractor to generate forged invoices to earn offset credit.²²⁵ In the event of a conviction, a commercial bribe could result in imprisonment and a fine that is double the pecuniary gain or loss resulting from the commercial bribe.²²⁶

C. Recordkeeping And Internal Control Violations

In addition to rules prohibiting a bribe itself, international law also criminalizes the maintaining of books and records that conceal or mischaracterize bribe transactions. The FCPA, for example, has two rules applicable to issuers of securities²²⁷ in the U.S.: its requirement for issuers to make and keep accurate, reasonably detailed books and records, and its requirement for issuers to maintain an adequate system of internal accounting controls.²²⁸ Other countries, such as the United Kingdom, impose similar duties on companies to maintain adequate accounting records,²²⁹ but the FCPA provisions are notable for the increasing number of enforcement actions for violations of their standards.²³⁰

²²⁴ To date, only one federal prosecution has resulted in a reported case charging commercial bribery under the Travel Act and Federal Wire Fraud Act. See *U.S. v. Welch*, 327 F.3d 1081 (2003) (commercial bribery of members of International Olympic Committee).

²²⁵ TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 14.

²²⁶ The Travel Act and Federal Wire Fraud Act may result in a maximum sentence of imprisonment up to 20 years, and a fine that may be twice the pecuniary gain from the bribe, twice the victim's loss, or \$100,000. 18 U.S.C. §§ 1343, 1952(a), 3571. The maximum punishment under the Bribery Act for commercial bribery is a fine and imprisonment up to 10 years. Bribery Act, 2010, c.23, § 11(1) (U.K.).

²²⁷ An issuer of securities is a publicly traded company which files an application with the Securities and Exchange Commission to register on a national securities exchange. 15 U.S.C. § 78l(b) (2012).

²²⁸ 15 U.S.C. § 78m(b)(2) (1998).

²²⁹ See Warin, *supra* note 204, at 35 (accounting requirements of U.K. Companies Act 2006).

²³⁰ Securities and Exchange Commission, *SEC Enforcement Actions: FCPA Cases* (May 24, 2012), <http://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml> (list of growing number of FCPA enforcement actions by the SEC per year). In 2010, the U.S. Department of Justice (DOJ) and Securities and Exchange Commission (SEC) had over 70 enforcement actions under the Foreign Corrupt Practices Act, with over \$1.4 billion in fines. TARUN, *supra* note 211, at xxvii; LOUGHMAN AND SIBERY, *supra* note 40, at 5.

A violation of the FCPA's recordkeeping provision exists if an issuer fails to make and keep books, records and accounts in reasonable detail that accurately and fairly reflects the transactions and dispositions of the issuer's assets.²³¹ The recordkeeping rule essentially requires a company paying a bribe to record the transaction as a bribe, and not conceal the payment as another type of transaction.²³² The FCPA's internal control provision is violated if an issuer fails to devise and maintain a system of internal accounting controls sufficient to meet specified statutory objectives.²³³ These objectives require issuers, for example, to record transactions in a way permitting accountability of assets.²³⁴

The penalties for violating the FCPA's recordkeeping and internal controls provisions are, in theory, more severe than those for its anti-bribery provisions. For a willful violation, individuals may be imprisoned up to 20 years and fined up to \$5,000,000, while companies may be fined up to \$25,000,000.²³⁵ However, disgorgement of profits may result in much higher sanctions than actual fines; for example, when the SEC settled with Chevron Corp. regarding internal control violations that allowed Chevron's third-party contractors to pay \$20 million in kickbacks to the Iraqi government, the settlement required Chevron to disgorge \$25 million in profits, but pay \$5 million in civil

²³¹ 15 U.S.C. § 78m(b)(2)(A) (1998).

²³² TARUN, *supra* note 211, at 13.

²³³ 15 U.S.C. § 78m(b)(2)(B) (1998).

²³⁴ 15 U.S.C. § 78m(b)(2)(B) (1998). The FCPA's full requirements are that an issuer provide reasonable assurances that (1) transactions are executed in accordance with management authorization, (2) transactions are recorded as necessary to permit preparation of conforming financial statements and maintain accountability for assets, (3) access to assets is permitted only according to management authorization, and (4) recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken on discrepancies. *Id.*

²³⁵ 15 U.S.C. § 78ff(a).

penalties.²³⁶ In the face of such severe monetary sanctions, it is incumbent on defense vendors to prevent liability under the FCPA.

D. Failure Of A Commercial Organization To Prevent Bribery

In addition to bribery and records violations, the Bribery Act created a new offense in 2011 when it made companies liable for failing to prevent persons associated with them from committing bribery.²³⁷ This prohibition has been compared to the FCPA's recordkeeping and internal controls provisions, because both the U.K. and U.S. laws require companies to operate internal anti-corruption programs in order to comply with their provisions.²³⁸ However, the Bribery Act's provisions are broader than the FCPA's due to its broader jurisdictional and liability standards.

A commercial organization fails to prevent bribery if a person associated with it bribes another person intending to retain business, or obtain or retain an advantage, for the company.²³⁹ An "associated person" is defined as a person who performs services for or on behalf of the company; the capacity of that individual is immaterial.²⁴⁰ The Bribery Act states an employee, agent or subsidiary may meet the definition of associated person, but the broad definition of associated person could also mean contractors, suppliers and joint venture partners.²⁴¹ Additionally, the person offering the bribe does not have to be

²³⁶ Securities and Exchange Commission, *Chevron to Pay \$30 Million to Settle Charges for Improper Payments to Iraq Under U.N. Oil for Food Program*, Press Release 2007-230 (Nov. 14, 2007), <http://www.sec.gov/news/press/2007/2007-230.htm>.

²³⁷ Bribery Act, 2010, c.23, § 7 (U.K.).

²³⁸ Warin, *supra* note 204, at 8.

²³⁹ Bribery Act, 2010, c.23, § 7(1) (U.K.).

²⁴⁰ *Id.* at § 8(1).

²⁴¹ *Id.* at § 8(3); Ministry of Justice, *supra* note 211, at 16 (U.K.). Guidance by the U.K. Ministry of Justice (MOJ) states the degree of control a company has over an entity will be taken in to account in prosecution decisions, and the fact a company benefits indirectly from a third party's bribe is unlikely, by itself, to prove the entity intended to benefit the company. Ministry of Justice, *supra* note 211, at 17. However, this assurance is cold comfort because the MOJ determines if an offense occurred by examining the intent of the bribe-giving party; the crime of failing to prevent bribery imposes strict liability for the company.

prosecuted in order for the company to be held liable, and the bribe itself may be offered or given to either a commercial or governmental entity.²⁴²

The broad jurisdiction of the failure to prevent bribery offense is also remarkable. The FCPA's recordkeeping and internal control provisions apply only to issuers of U.S. securities; however, failure to prevent bribery applies to any incorporated body or partnership which carries on a business, or part of a business, in any part of the U.K.²⁴³ The MOJ has stated the listing of securities in the U.K., or the existence of a U.K. subsidiary, does not automatically mean a company is carrying on business in the U.K.; additionally, the Director the Serious Fraud Office (SFO) has stated that "carrying on business" means "economic engagement" with the U.K., such as trading raising finance, carrying out corporate functions, or dealing with numerous stakeholders.²⁴⁴ However, because the U.K. is one of the seven largest defense markets in the world, as measured by expenditures and percentage of GDP,²⁴⁵ it is likely that a major defense vendor would conduct enough business in the U.K. to trigger liability under the Bribery Act. Moreover, the SFO has stated its priority in prosecutions for failure to prevent bribery is to target foreign companies that, by committing foreign bribery, deprive an ethical U.K. company of a business opportunity.²⁴⁶ Because British companies frequently compete in

Bribery Act, 2010, c.23, § 7(1) (U.K.); Ministry of Justice, *supra* note 211, at 17; TARUN, *supra* note 211, at 432.

²⁴² Bribery Act, 2010, c.23, §§ 1, 6, 7(3)(a) (U.K.).

²⁴³ 15 U.S.C. § 78m(a); Bribery Act, 2010, c.23, § 7(5) (U.K.).

²⁴⁴ Ministry of Justice, *supra* note 211, at 15-16; ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, PHASE 3 REPORT ON IMPLEMENTING THE OECD ANTI-BRIBERY CONVENTION IN THE UNITED KINGDOM 15 (2012); LOUGHMAN AND SIBERY, *supra* note 40, at 30 [hereinafter OECD Phase 3 Report].

²⁴⁵ *World Wide Military Expenditures – 2011*, GlobalSecurity.org (Sep. 7, 2011), <http://www.globalsecurity.org/military/world/spending.htm>; *Military Ranking: The World's Biggest Defence Budgets*, THE ECONOMIST (Mar. 9, 2011), http://www.economist.com/blogs/dailychart/2011/03/defence_budgets.

²⁴⁶ OECD Phase 3 Report, *supra* note 244, at 15.

international defense procurements, this limit on prosecutorial discretion does not seem to provide much assurance in the context of defense sales.

E. False Claims In Foreign Military Sales

In addition to liability from statutes with general applicability to corrupt practices, a corrupt transaction occurring through the FMS program may create liability under the False Claims Act (FCA).²⁴⁷ The FCA makes it illegal to knowingly present, or cause to be presented, a false or fraudulent claim for payment or approval by the U.S. government.²⁴⁸ In *United States ex rel. Campbell*, the District Court for the District of Maryland held that invoices processed through FMS may face FCA liability if fraudulent.²⁴⁹ Specifically, the District Court held that invoices submitted to DOD due to FMS met the definition of a claim for payment by the U.S. government under the FCA.²⁵⁰ Additionally, the Court held that even though FMS items are resold to a foreign government, and the U.S. government is reimbursed for all of its FMS expenses, this does not allow a defense vendor to escape FCA liability.²⁵¹ A vendor's fraudulent claim to the U.S. government establishes FCA liability, and a subsequent government-to-government sale does not excuse or eliminate such liability.²⁵² Therefore, a false invoice from a

²⁴⁷ See DISAM, supra note 171, at 9-10 to 9-20, 15-10 (offset availability in FMS); *Campbell*, supra note 177, at 1342 (FCA applicability to FMS).

²⁴⁸ 31 U.S.C. § 3729(a)(1) (2009).

²⁴⁹ *Campbell*, supra note 177, at 1329, 1340. In the only other reported case to consider the question, the reasoning and holding of *United States ex. rel Campbell* was confirmed in *United States ex rel. Hayes v. CMC Elec., Inc.*, 297 F.Supp.2d 734, 737-738 (D.C.N.J. 2003).

²⁵⁰ 31 U.S.C. § 3729(a)(1) (2009). *Campbell*, supra note 177, at 1329, 1340.

²⁵¹ *Campbell*, supra note 177, at 1342.

²⁵² *Id.*

vendor, or a false record or statement from a subcontractor that is material to a vendor's invoice, could result in FCA liability.²⁵³

Liability under the FCA is broad because the FCA requires no proof of specific intent to defraud, but only requires actual knowledge of information, an act in deliberate ignorance of the truth or falsity of information, or reckless disregard of the truth or falsity of information.²⁵⁴ Finally, liability under the FCA may be especially onerous due to the FCA's award of penalties at three times the amount of damages sustained by the government.²⁵⁵ The threat of treble damages often results in settlement of FCA suits; for example, in 2009 Northrop Grumman agreed to pay DOJ \$325 million in fines to settle an allegation that the defense contractor made misrepresentations to the federal government when it sold defective satellite parts.²⁵⁶ Because FCA prosecutions have collected over \$24 billion in fines for the federal government since 1986,²⁵⁷ FCA liability poses substantial financial risk for defense contractors facing prosecution.²⁵⁸

V. TRACING CORRUPTION PATHWAYS IN OFFSET TRANSACTIONS

²⁵³ 31 U.S.C. §§ 3729(a)(1)(A), 3729(a)(1)(B) (2009).

²⁵⁴ See 31 U.S.C. §§ 3729(b)(1) (2009) (FCA definition of knowledge).

²⁵⁵ 31 U.S.C. §§ 3729(a)(1), 3730(b)(1) (2009).

²⁵⁶ Department of Justice, Northrop Grumman Corp. Settles False Claims Act Case for Defective Satellite Parts, Press Release 09-305 (April 2, 2009), <http://www.justice.gov/opa/pr/2009/April/09-ag-305.html>.

²⁵⁷ Lt. Gov. Brown Applauds Senate Judicial Proceedings Committee Favorable Vote on Maryland False Health Claims Act, U.S. FEDERAL NEWS, March 13, 2010.

²⁵⁸ In addition to the financial risk posed by an FCA prosecution, a defense vendor who fails to timely disclose credible evidence of an FCA or Title 18 violation may also face suspension or debarment from federal contracting. FAR § 3.1003(a)(2); FAR § 9.406-2(b)(1)(vi); FAR § 9.407-2(a)(8). Contractors who are debarred, suspended, or proposed for debarment are excluded from being awarded new federal contracts. FAR § 9.405(a). Generally, debarments should not exceed 3 years, and suspensions are for a temporary period pending the completion of investigation or legal proceedings that may not exceed 18 months. FAR § 9.406-4; FAR § 9.407-4. Notwithstanding the debarment, suspension, or proposed debarment, an agency may continue contracts or subcontracts in existence at the time the contractor was debarred, suspended, or proposed for debarment unless the agency head directs otherwise. FAR § 9.405-1.

Offsets are at risk for corruption at several points in an offset transaction. In the formation stage, a bribe to a government official may skew an offset's valuation as an award criterion, generate an unnecessary offset requirement, or determine a sole source offset award.²⁵⁹ In the performance stage, an offset may operate as a sham transaction to siphon funds to corrupt government officials, or it may prompt a bribe in exchange for fraudulent offset credit.²⁶⁰ These corrupt practices succeed through the exploitation of an offset's award criteria, valuation mechanisms, and sole sourcing provisions, and by utilizing non-transparent parts of the procurement process to avoid public detection of corrupt conduct.

A. Formation Of Offset Proposals

During the negotiation and award of a defense procurement, a party may bribe a foreign official to skew the evaluation of an offset proposal in order to improperly award the defense procurement to a particular foreign vendor, or to improperly award an offset subcontract to a particular domestic contractor.²⁶¹ To affect an offset's evaluation, these schemes require the foreign official to manipulate the offset's valuation, sole sourcing, and transparency flaws.

When a party bribes a foreign official, the party will most frequently arrange for an electronic transfer of money from an intermediary into a corrupt official's bank account.²⁶² Such a bribe to a foreign official will then be falsely recorded, for example,

²⁵⁹ See FEINSTEIN, *supra* note 41, at 177-178, 182 (offset valuation scheme in South African procurement); TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 18-19, 43 (corruption in award of offsets).

²⁶⁰ FEINSTEIN, *supra* note 41, at 83-84; TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 17.

²⁶¹ See TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 18 (list of corruption risks in offsets).

²⁶² ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, BRIBERY IN PUBLIC PROCUREMENT: METHODS, ACTORS AND COUNTER-MEASURES 47 (2007) [hereinafter OECD Bribery in Public Procurement].

as a consultant fee or marketing expense.²⁶³ Alternately, a party may deliver its bribe through tangible assets such as cash, gifts, travel and entertainment.²⁶⁴ The use of an intermediary—such as an agent, consultant, or an official’s family member—is done to conceal the briber’s identity in an arm’s-length transaction.²⁶⁵ A vendor may approve or condone of an agent’s bribery, or an agent may issue a bribe on its own without a vendor’s actual knowledge or approval.²⁶⁶ Regardless, a vendor is liable under the FCPA for the indirect bribes of its agents, and may also be liable under the Bribery Act for failure to prevent bribery if there are multiple instances of bribery.²⁶⁷

Some observers, such as former Senator Russell Feingold, have argued that defense offsets in and of themselves seem “pretty damn close to [a bribe].”²⁶⁸ However, when analyzing the corrupt award of offset and defense sales contracts, it is important to distinguish between an offset acting as a bribe, versus an offset as a reward for a bribe. A bribe exists if a person offers an undue payment to a foreign official in order to obtain or retain business.²⁶⁹ Anti-bribery laws such as the FCPA and Bribery Act state a bribe can be “anything of value,” so a foreign vendor’s improper offer of offset business could

²⁶³ OECD Bribery in Public Procurement, *supra* note 262, at 39-40; see FEINSTEIN, *supra* note 41, at 83 (BAE Systems’ categorizing bribes to Saudi officials as a marketing expense); Leigh and Evans, *Al-Yamamah*, *supra* note 2 (BAE Systems’ categorizing bribes to Saudi officials as a marketing expense).

²⁶⁴ See OECD Bribery in Public Procurement, *supra* note 262, at 47 (forms that a bribe may take).

²⁶⁵ See *id.* at 38-40, 41-42 (use of intermediaries to offer bribes in government procurement).

²⁶⁶ Department of Justice, *Oil Services Companies and a Freight Forwarding Company Agree to Resolve Foreign Bribery Investigations and to Pay More Than \$156 Million in Criminal Penalties*, Press Release 10-1251 (Nov. 4, 2010), <http://www.justice.gov/opa/pr/2010/November/10-crm-1251.html>; OECD Bribery in Public Procurement, *supra* note 262, at 37.

²⁶⁷ TARUN, *supra* note 211, at 7, 432; 15 U.S.C. §§ 78dd-1(a)(3), -2(a)(3), -3(a)(3); Bribery Act, 2010, c.23, § 7(1) (U.K.); Ministry of Justice, *supra* note 211, at 17.

²⁶⁸ Charles M. Sennott, *US Sees Conflict of Interest over Arms Commerce*, BOSTON GLOBE, May 9, 1996, at 1. In addition, one economist has called the issuance of offsets “the equivalent of what we used to do when we bribed foreign officials. Leslie Wayne, quoting Robert E. Scott, *A Well-Kept Military Secret*, N.Y. TIMES, Feb. 16, 2003, § 3 at 1. Finally, other observers have equated offsets to “bribes and corporate welfare.” Derrick Z. Jackson, *US Plays the Arms Sales Game*, BOSTON GLOBE, Feb. 21, 2003, at A19.

²⁶⁹ OECD Anti-Bribery Convention, 37 I.L.M. 1, art. 1; 15 U.S.C. §§ 78dd-1. -2, -3; Bribery Act, 2010, c.23, § 6 (U.K.).

constitute a bribe; however, to constitute a bribe an offset must also be awarded to a government official.²⁷⁰ An example of an offset constituting a bribe was alleged in South Africa, where a foreign vendor was accused of awarding an offset contract to a company that issued some of its shares, for free, to the South African defense minister.²⁷¹ In this instance the gift of stock was a bribe, and the prospect of offset proceeds getting funneled to the corrupt official constituted an additional bribe.²⁷² However, the act of awarding offset business to the constituents of an official is not illegal unless it is an improper commercial bribe per the Bribery Act, fraudulent per the Wire Fraud Act, or distributes the proceeds of bribery per the Travel Act.²⁷³ An offset, in and of itself, is not a bribe.

Offsets are not unique in how money is exchanged in a bribe transaction; instead, they are unusual in how they exploit confidential mechanisms in the procurement process in order to unlawfully award a procurement. The first example of such an exploitation is a government official's manipulation of an offset's valuation in order to award a procurement to a bribing vendor. Specifically, a government official, as payback for a bribe, may improperly inflate an offset's valuation to award a defense procurement to a corrupt vendor.²⁷⁴ For this scheme to work, an offset must be an award criterion, and

²⁷⁰ 15 U.S.C. §§78dd-1(a), -2(a), -3(a); Bribery Act, 2010, c.23, § 6(3).

²⁷¹ FEINSTEIN, *supra* note 41, at 181.

²⁷² *Living with the U.S. Foreign Corrupt Practices Act (FCPA) in an Era of Enhanced Enforcement*, 22 SPG INT'L LAW PRACTICUM 3, 5 (2009) (gift of stock as a bribe under the FCPA). Such a transaction may also constitute a bribe under local bribery laws; see Daniel Y. Jun, *Bribery Among the Korean Elite: Putting an End to a Cultural Ritual and Restoring Honor*, 29 VAND. J. TRANSNAT'L L. 1071, 1090 (1996) (state official's receipt of stock acted as a bribe under Korean bribery law); OECD Bribery in Public Procurement, *supra* note 262, at 47 (gift of stocks as a bribe).

²⁷³ See Bribery Act, 2010, c.23, § 1 (U.K.) (elements of commercial bribery under Bribery Act); 18 U.S.C. § 1952 (2002) (elements of Travel Act); 18 U.S.C. § 1343 (2008) (elements of Wire Fraud Act).

²⁷⁴ See FEINSTEIN, *supra* note 41, at 177-178, 182 (offset valuation scheme in South African procurement).

government officials must abuse their discretion to illegally inflate the valuation of an offset proposal.²⁷⁵

Offset valuation is prone to improper cost inflation because these figures, even within legitimate deals, are complicated by several risk factors. First, valuation involves the use of proprietary source selection data, so valuation information cannot be disclosed to outside parties for public scrutiny.²⁷⁶ Second, because offsets allocate direct offset work to domestic contractors which are not as efficient as their international competition, offsets require vendors to add a cost premium onto the price of a defense acquisition.²⁷⁷ This cost premium depends on production costs, such as an item's price and marketability if resold in countertrade, as well as transaction costs, such as exchange rate, inflation, default and moral-hazard risks.²⁷⁸ Third, offset valuation may be complicated by the unavailability of market data for the subject of an offset, or by a lack of reliable data on how successfully an offset recipient will fulfill its offset contract.²⁷⁹ Fourth, valuing an offset may be speculative if it requires a defense vendor to develop new business for an offset recipient by investing money, skill or technology into that firm; the offset may condition the offset's discharge on the investment's success, yet such an outcome may be

²⁷⁵ See Eriksson, *supra* note 33, at 30 (offsets used as an award criterion in E.U. Member States, ranging from 12.5 to 20 percent of a procurement's evaluation points); FEINSTEIN, *supra* note 41, at 177-178, 182 (manipulation of offset valuation in a South African procurement).

²⁷⁶ For example, in U.S. procurements, proposed costs or prices constitute protected source selection information. FAR § 2.201. The U.S. government is prohibited from disclosing cost or pricing data to a purchasing government without the consent of the vendor. DFARS § 225.7304(c); DoD 5105.38-M, *supra* note 70, at C6.3.9.1.

²⁷⁷ Markowski and Hall, *supra* note 54, at 49.

²⁷⁸ Robert Howse, *Beyond the Countertrade Taboo: Why the WTO Should Take Another Look at Barter and Countertrade*, 60 U. TORONTO L.J. 289, 310 (2010).

²⁷⁹ Nobles and Lang, *supra* note 112, at 749 (offset valuation as a weak point); GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 2 (lack of market data); Markowski and Hall, *supra* note 54, at 47, 49 (lack of market data, imperfect data on merits of a local contractor).

unknowable at the time of offset formation.²⁸⁰ But finally, and most crucially, offset valuation is prone to improper inflation because purchasing governments may not value an offset based on cost, but on multiple formulae subject to manipulation.²⁸¹ For example, to value technology transfer, offset parties may utilize the item's reproduction cost, replacement cost, projected production run, estimated income stream, or anticipated future profits.²⁸²

These multiple risk factors make valuing an offset, before offset work has even begun, highly speculative and subject to manipulation. For example, when the consortium producing the Eurofighter Typhoon bid on a Norwegian fighter jet procurement in 1999, several billion dollars separated the offset valuations calculated by the defense vendor (26.7 billion Norwegian krone, or \$4.4 billion), Norwegian industry (16 billion Norwegian krone, or \$2.6 billion), and the Norwegian defense ministry (4.5 billion Norwegian krone, or \$740 million).²⁸³ In this instance, the purchasing government acted as a brake on wildly optimistic offset valuations; however, with a corrupt government, the offset valuations in the Norwegian example can be turned on their head, with a corrupt purchasing government official overselling an offset's value in exchange for a bribe.

Unfortunately, such an allegation of corrupt offset manipulation was raised in the procurement of a training jet in South Africa.²⁸⁴ In a three-way competition, a British bid allegedly received the lowest score on both technical and cost criteria; however, when

²⁸⁰ See Dumas, *supra* note 15, at 23-24 (risk of failure when defense vendors work as venture capital firms for offsetting companies).

²⁸¹ See Jang, *supra* note 99, at 93; UNCITRAL LEGAL GUIDE, *supra* note 99, at 71-72 (valuation of technology transfer based on estimated future royalties).

²⁸² Jang, *supra* note 99, at 93-94; UNCITRAL LEGAL GUIDE, *supra* note 99, at 71-72.

²⁸³ Matthews, *supra* note 81, at 98; The Money Converter, *supra* note 2.

²⁸⁴ FEINSTEIN, *supra* note 41, at 177, 182.

financing and a substantial offset proposal were factored into the bid, the South African Defense Ministry ranked the British proposal as the most advantageous.²⁸⁵ When the South African Department of Trade and Industry conducted its own analysis of the British offsets' valuation, the Department of Trade and Industry allegedly disputed the offset valuation, stating the offsets' value was "grossly inflated" from \$245 million to \$1.6 billion.²⁸⁶ Nevertheless, the British bid received the award for the South African contract.²⁸⁷ It is suspected that bribery is what caused the South African offsets' valuation to increase by a factor of six.²⁸⁸

Bribery may also cause an illegal award of an offset subcontract to a company local to the purchasing country. Such a bribe could occur in two parts of the procurement process: during the creation of offset proposals, where an offset could be created to benefit a particular local company, and during the award of offset subcontracts.²⁸⁹ In order for such a scheme to work as the reward for a bribe, a domestic company must bribe a purchasing government official to require the offset subcontract to be awarded directly to a local contractor as a sole source contract.²⁹⁰

In offset negotiations, a bribe to create an improper offset could be obscured among the hundreds of offset proposals that are typically reviewed before a final offset package is agreed upon.²⁹¹ Moreover, an improperly influenced offset proposal could enter into discussions through the input of third parties pitching offset proposals to offset brokers

²⁸⁵ Id. at 177-178.

²⁸⁶ Id. at 178.

²⁸⁷ Id. at 180.

²⁸⁸ Id. at 179.

²⁸⁹ TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 17-18.

²⁹⁰ See LOUGHMAN AND SIBERY, *supra* note 40, at 298.

²⁹¹ See GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 1 (offset negotiations required prior to contract award); Redlich and Miscavage, *supra* note 34, at 403 (over 100 offset opportunities identified in offset negotiations with Israel); Seguin, *supra* note 36, at 22 (104 offset commitments in F-16 sale to Poland).

(and colluding with corrupt parties).²⁹² By inserting an offset proposal through a third party’s “reverse piggyback offset,” a corrupt government official could effectively remove his or her fingerprints from such a corrupt deal.²⁹³

In the award of offset contracts to local contractors, government officials could direct a defense vendor to make an award to a particular subcontractor in a DCS transaction, or require a sole source award in an FMS transaction.²⁹⁴ For example, an Asian government in the 1990s specified in its FMS purchase of an airplane that it would select the companies which would manufacture airframes in accordance with an offset.²⁹⁵ This sole source was justified by stating all four of the domestic aerospace companies needed to participate and achieve a proportionate share of subcontracting work.²⁹⁶ Such apportionments are made in the interest of national security, so more than one defense vendor remains capable of manufacturing a key weapon component.²⁹⁷ However, if a sole source is made due to cronyism, nepotism, or other improper relationships with government officials, such a national security justification may also mask an improper offset award.²⁹⁸ This is especially important for defense vendors because they are often required to partner with local companies, forming joint ventures or consortiums, and a

²⁹² GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 1 (offsets as a condition initiated by a purchaser); Marvel, *supra* note 100, at 36 (“reverse piggyback offsets” initiated by third parties).

²⁹³ Marvel, *supra* note 100, at 36 (“reverse piggyback offsets” initiated by third parties).

²⁹⁴ See *Id.*, DFARS § 225.7304(a) (prime and subcontractor designation in FMS); DoD 5105.38-M, *supra* note 70, at C6.3.4.2 (prime and subcontractor designation in FMS).

²⁹⁵ U.S. GENERAL ACCOUNTING OFFICE, GAO/NSIAD-99-35, DEFENSE TRADE: U.S. CONTRACTORS EMPLOY DIVERSE ACTIVITIES TO MEET OFFSET OBLIGATIONS 5 (1998) [hereinafter GENERAL ACCOUNTING OFFICE, GAO/NSIAD-99-35].

²⁹⁶ *Id.*

²⁹⁷ In a U.S. procurement, the manufacture of the F-35’s jet engines was directed to be awarded to two U.S. manufacturers—General Electric and Pratt Whitney—on the grounds that it was required to maintain the defense industrial base, and that it was required to lower prices through competition. Penny Wise, Pound Foolish F-35 Alternate Engine Recommendation Should be Rejected by Congress...Again, BARTLETT (February 14, 2012), <http://bartlett.house.gov/news/documentprint.aspx?DocumentID=225080>; GENERAL ACCOUNTING OFFICE, GAO-03-775, *supra* note 165, at 1.

²⁹⁸ See TRANSPARENCY INT’L, DEFENSE OFFSETS, *supra* note 10, at 14 (cronyism and nepotism as incentives for bribery in award of offsets).

local company's bribe to obtain offset business could make the defense vendor liable for the actions of the local partner.²⁹⁹

B. Award Of Offset Credit

In the performance phase of an offset, there are many ways for corruption to affect an offset transaction. First, an offset can be a sham transaction used to siphon funds to government officials.³⁰⁰ Second, a vendor may use a bribe to improperly receive offset credit and discharge of offset obligations.³⁰¹ Such a corrupt payment may be offered as a bribe to a commercial entity to obtain fraudulent offset documentation,³⁰² as a bribe to a government official to grant unearned offset credits,³⁰³ or as a bribe in response to a government official's extortion.³⁰⁴

As with bribery in the formation process, a bribe in the performance phase will most likely be delivered by an intermediary through a deposit of funds into a government official's bank account.³⁰⁵ However, because an offset will establish ongoing business in the purchasing country, bribes may also be delivered by free use of a company credit card, the offer of free shares in a company, or a loan that is not reimbursed.³⁰⁶ Moreover,

²⁹⁹ LOUGHMAN AND SIBERY, *supra* note 40, at 299; see also GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 2 (Saudi offsets requiring joint ventures with local companies).

³⁰⁰ See Leigh and Evans, *Al-Yamamah*, *supra* note 2; Pallister, *supra* note 2, at 9 (reimbursement of bribes in Al Yamamah contracts); FEINSTEIN, *supra* note 41, at 83-84.

³⁰¹ TRANSPARENCY INT'L, DEFENSE OFFSETS, *supra* note 10, at 14, 17.

³⁰² *Id.* at 17.

³⁰³ *Id.* at 14.

³⁰⁴ OECD Bribery in Public Procurement, *supra* note 262, at 46; *Lockheed's Commission Payments to Obtain Foreign Sales: Report to the Chairman, S. Comm. On Banking, Housing and Urban Affairs, 95th Congress 7 (1977)* (statement of Robert F. Keller, Acting Comptroller General) (bribes paid overseas usually made as a grease payment, a payment to secure competitive advantage, or a payment in response to extortion).

³⁰⁵ See OECD Bribery in Public Procurement, *supra* note 262, at 41-42, 47.

³⁰⁶ *Id.* at 47.

an offset may constitute a sham transaction that files a false claim against a purchasing government in order to siphon funds to a corrupt government official.

When an offset package is negotiated between a corrupt vendor and government official, they may agree to create sham transactions which the vendor can bill to reimburse the costs of other corrupt activities, such as bribes.³⁰⁷ Bribery typically occurs over many years, and bribed government officials collect payments both at the beginning and over the course of a business relationship in order to fully realize the ill-gotten gains they expect.³⁰⁸ Therefore, if a vendor can obtain a corrupt official's agreement, a vendor would prefer to file a series of false claims against a purchasing government in order to pay for its escalating bribery costs. This is illustrated by the alleged bribery that occurred between BAE Systems and corrupt Saudi officials.³⁰⁹ The initial bribes in BAE Systems' Saudi contracts were between £300 and £600 million (\$460 million and \$921 million), but the final amount of bribery over the 20-year course of the Saudi deal are estimated at over £6 billion (\$9.7 billion).³¹⁰ Throughout the duration of its Saudi contracts, BAE Systems allegedly bribed Saudi officials through false commissions and hospitality

³⁰⁷ See Leigh and Evans, *Al-Yamamah*, supra note 2; Pallister, supra note 2, at 9 (reimbursement of bribes in Al Yamamah contracts).

³⁰⁸ OECD Bribery in Public Procurement, supra note 262, at 45.

³⁰⁹ BAE Systems has not admitted to or been found guilty of bribery in the Al Yamamah scandal. In February 2010, it entered into an agreement with the SFO admitting to bribery in Tanzania, but not in Saudi Arabia. OECD Phase 3 Report, supra note 244, at 15. In March 2010, BAE Systems pled guilty in the U.S. to making false statements, but did not plead guilty to bribery. Department of Justice, *BAE Systems PLC Pleads Guilty and Ordered to Pay \$400 Million Criminal Fine*, Press Release 10-209 (Mar. 1, 2010), <http://www.justice.gov/opa/pr/2010/March/10-crm-209.html>. Such a result occurred, in no small part, because in December 2006 Saudi officials threatened to cease co-operation with the U.K. on intelligence and security issues if the U.K. continued to investigate allegations that BAE Systems had bribed Saudi officials to the the Al Yamamah contract. In response to this threat, the SFO terminated its investigation in the Al Yamamah case. Despite calls by the OECD, among others, for the U.K. to re-open the Al Yamamah investigation, the SFO has failed to do so. OECD Phase 3 Report, supra note 244, at 15.

³¹⁰ FEINSTEIN, supra note 41, at 76; Leigh and Evans, *Al-Yamamah*, supra note 2; see The Money Converter, supra note 2, for conversion from U.K. pounds to U.S. dollars.

payments.³¹¹ BAE Systems would falsely record its commission as “marketing services,” and describe hospitality payments as “accommodation, services and support for overseas visitors.”³¹² BAE Systems would also allegedly hide bribes in inflated bills from Saudi contractors.³¹³ Additionally, BAE Systems is accused of charging these mischaracterized expenses to the U.K. Ministry of Defense, which would then seek reimbursement from the Saudi government, as is done in an FMS government-to-government contract.³¹⁴ Therefore, with collusion from corrupt Saudi officials, BAE Systems was able to get reimbursed for its bribes through false claims and records.³¹⁵

A second way for offsets to serve as a basis for corruption is for a defense vendor to bribe an offset recipient into providing false documentation for an offset credit claim, or to bribe a foreign official for a grant of offset credit.³¹⁶ A bribe to earn fraudulent offset credit may occur if a vendor is in danger of failing to perform an offset, because such a default would result in the vendor being debarred from receiving future procurements from the offended government.³¹⁷ To avoid killing its business, a desperate vendor may choose to bribe an offset recipient in order to receive invoices unrelated to offset work, and then attempt to pass the invoices off as completed offset work.³¹⁸ Such a bribe would not necessarily have to be in regard to the failing offset; a bribe for unearned offset credit could also occur in the context of fraudulently receiving banked

³¹¹ FEINSTEIN, *supra* note 41, at 75, 79-80.

³¹² *Id.* at 83; Leigh and Evans, *Al-Yamamah*, *supra* note 2.

³¹³ Leigh and Evans, *Al-Yamamah*, *supra* note 2; see *The Money Converter*, *supra* note 2, for conversion from U.K. pounds to U.S. dollars.

³¹⁴ FEINSTEIN, *supra* note 41, at 83-84; Pallister, *supra* note 2, at 9; see DISAM, *supra* note 171, at 9-20 (U.S. government is the “banker” for offset transactions in FMS).

³¹⁵ See 15 U.S.C. § 78m(b)(2) (elements of recordkeeping and internal control offenses); 31 U.S.C. § 3729(a)(1) (2009) (elements of False Claims Act); Bribery Act, 2010, c.23, § 7 (U.K.) (failure to prevent bribery).

³¹⁶ TRANSPARENCY INT’L, DEFENSE OFFSETS, *supra* note 10, at 17.

³¹⁷ Romero, *supra* note 123.

³¹⁸ TRANSPARENCY INT’L, DEFENSE OFFSETS, *supra* note 10, at 17.

offset credits.³¹⁹ Alternately, a vendor may choose to bribe a government official to receive offset credit; such an operation could be achieved through the manipulation of an offset's valuation formula, or by a government official giving credit for non-offset work.³²⁰ For example, in South Africa a Swedish company received an indirect offset to upgrade a spa in Port Elizabeth, and to market travel to this spa to Swedish tourists.³²¹ The cost of the vendor's investment was \$3 million; however, the Swedish vendor allegedly claimed \$218 million in offset credits because the offset allowed it to receive \$3,830 in credit for each Swedish tourist traveling in South Africa, and not just Port Elizabeth.³²² During the offset's performance period, South Africa hosted the World Cup, so the Swedish vendor potentially received credit for every Swedish tourist in attendance, many of whom presumably had never heard of the offset's spa.³²³ Whether this situation occurred through corruption, bad judgment or irrational accounting rules is impossible to say, but this example's credit value—over 70 times the original investment—illustrates how offset credits may be manipulated for corrupt purposes.

Finally, government officials may extort a bribe by manipulating multiple valuation tools in an offset agreement to create leverage for such a purpose. Over the last 15 years, many countries have required vendors to deliver offsets valued at over 100 percent of the original contract's purchase price.³²⁴ Such astronomical valuations are created with the help of offset multipliers.³²⁵ If a multiplier is used in a vendor's favor, it lessens the cost

³¹⁹ See Verma, *supra* note 64, at 1 (concern over receipt of unearned banked offset credits).

³²⁰ See *id.*

³²¹ FEINSTEIN, *supra* note 41, at 180.

³²² *Id.*

³²³ *Id.*

³²⁴ Eriksson, *supra* note 33, at 30; see also DEP'T OF COMMERCE, TWELFTH STUDY, *supra* note 33, at Appendix F (offsets as part of procurement decision).

³²⁵ GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 1.

burden of an offset;³²⁶ however, a failure to credit an offset with multiplied value could also be manipulated to put pressure on a vendor for a bribe. This is especially true if an offset has criteria which are difficult to satisfy, or if the business environment in a country does not provide alternate businesses with which to make offset partnerships.³²⁷ Additionally, if an offset agreement has penalty clauses,³²⁸ a corrupt government official may leverage these for a bribe as well. Some purchasing countries recognize this extortion risk and allow vendors to accumulate and trade banked offset credits;³²⁹ however, as previously discussed, banked credits do not check the significant discretion offset officials have in valuing and granting offset credits, and do not bring transparency to offset transactions that are privileged or classified.³³⁰ To bring transparency to offset transactions, governments must significantly reform their national offset rules.

VI. REDUCING THE RISK OF CORRUPTION IN DEFENSE OFFSETS

Because the risk of corruption in defense offsets is significant, and extends throughout the lifecycle of an offset, governments and defense vendors must take comprehensive measures to deter and detect it. Specifically, to promote governmental reform, the OECD should advocate for an international convention creating basic standards for offset transparency, valuation and competition. Moreover, defense vendors should institute

³²⁶ U.S. GENERAL ACCOUNTING OFFICE, GAO-01-278T, DEFENSE TRADE: OBSERVATIONS ON ISSUES CONCERNING OFFSETS 1-2 (2000) [hereinafter GENERAL ACCOUNTING OFFICE, GAO-01-278T].

³²⁷ See GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, supra note 9, at 4 (United Arab Emirates offsets difficult to satisfy due to their crediting only an offset's profit).

³²⁸ DEP'T OF COMMERCE, SIXTEENTH STUDY, supra note 9, at 3. Penalty clauses may, for example, increase the amount of a required offset obligation, reduce the value of a signed export sales contract, or require liquidated damages. *Id.* Half of the offset agreements signed by U.S. companies in 2010 have penalty clauses. *Id.*

³²⁹ GENERAL ACCOUNTING OFFICE, GAO-01-278T, supra note 326, at 3.

³³⁰ See TRANSPARENCY INT'L, DEFENSE OFFSETS, supra note 10, at 16 (discretion of offset officials and secrecy surrounding offsets).

targeted offset compliance measures that heighten due diligence verification standards and that increase electronic audits of offset partner documents.

A. Proposed OECD Convention On Offsets

Current international offset practice is in need of standardization on basic offset practices. In the past, much of the international debate on offsets has focused on whether they are a discriminatory trade practice,³³¹ but any discussions on whether to ban offsets as an invalid trade practice have ultimately proven unsuccessful.³³² To move forward and reach an achievable consensus on offset reform, future OECD discussions should focus on establishing minimum standards for international offset practice, and not focus on the broader, principle-based debates of the past. At the present time, a discussion of offset best practices would be more likely to bear fruit because in May 2011, the E.U.'s Code of Conduct on Offsets established a baseline of consensus among most OECD Member States about how offsets should be managed.³³³ Specifically, the Code of Conduct requires Member States to publish more information about their offset policies, practices and existing offset commitments, and also requires Member States to improve transparency about their offset requirements in contract solicitations and subcontract awards.³³⁴ From the foundation created by the Code of Conduct, the OECD should strive

³³¹ See Eriksson, *supra* note 33, at 4-5, 25 (variety of offset approaches among EU Member States regarding direct and indirect offset preference, and disagreement among EU Member States on whether offsets are discriminatory trade practices); Georgopoulos, *Revisiting*, *supra* note 50, at 40 (discussion of whether offsets are justifiable based on national security or job creation, or are discriminatory); Brauer, *supra* note 65, at 59 (offset approach of countries depending on whether they are developed, developing or less developed).

³³² See BIALOS, *supra* note 29, at 96 (past unsuccess of OECD offset discussions).

³³³ See Code of Conduct on Offsets, *supra* note 162, at 1 (Code of Conduct promulgation in 2011). The OECD currently has 34 members, 22 of which are E.U. Member States. See <http://www.oecd.org/about/membersandpartners> (OECD members); http://europa.eu/about-eu/countries/index_en.htm (EU Member States).

³³⁴ Code of Conduct on Offsets, *supra* note 162, at 3-4.

to create higher standards for international offset practice in the areas of transparency, offset valuation, and award of offset contracts.

1. *Transparency Proposals*

To promote transparency, the Code of Conduct requires Member States to provide the European Defence Agency (EDA) with information on their national offset practices and underpinning policies, and to disclose all offset commitments in effect since the Code of Conduct's implementation.³³⁵ In addition, the Code of Conduct requires contract solicitations to clearly stipulate offset requirements and to make clear if offset is an award factor.³³⁶ These proposals are an improvement on prior offset practice because relevant and reliable information on European offsets was scarce before the Code of Conduct, and some Member States' national laws created confusion on how offsets were analyzed for award decisions.³³⁷ However, the OECD should seek to expand the Code of Conduct's transparency rules so that more offset information is publicly accessible. Specifically, the OECD should seek to promote transparency during the solicitation, offer, and award phases of an offset. Publishing more information during the evaluation and award process will give offerors greater insight into a purchasing government's decision-making process, and provide third parties with heightened awareness of the real costs and benefits of offset programs, and with increased ability to monitor offsets for corruption.³³⁸

³³⁵ *Id.* at 3.

³³⁶ *Id.* at 4.

³³⁷ Eriksson, *supra* note 33, at 3, 7-8, 29-30. Lithuania's offset law is an example of a confusing offset evaluation scheme: offsets in this country were not considered an award criterion, yet the winning bidder could be eliminated for the benefit of the runner-up if it did not accept a required offset arrangement. *Id.* at 30.

³³⁸ TRANSPARENCY INT'L, DUE DILIGENCE AND CORRUPTION RISK IN DEFENCE INDUSTRY OFFSET PROGRAMMES 31 (2012); see also OECD Bribery in Public Procurement, *supra* note 262, at 67 (need for increased transparency to increase detection risk for corrupt activity) [hereinafter TRANSPARENCY INT'L, DUE DILIGENCE].

During solicitation, purchasing governments should clearly state their offset requirements and make a declaration of whether offsets are an award criterion, as recommended by the Code of Conduct.³³⁹ In addition, purchasing governments should publish the valuation formula they intend to use to assess offset proposals. Such a requirement is particularly necessary for the valuation of technology, which is often based on projections of a proposal's future production, sales or profits.³⁴⁰ Making economic projections is inherently difficult, and one type of formula cannot be used in all situations. However, disclosure of a valuation formula would show whether a purchasing government is using reliable and relevant criteria to calculate an offset's value, or is using a method at risk of overstating projected benefits.³⁴¹ This proposal would promote the use of defensible formulas for economic projections, and would deter government officials from abusing their discretion.³⁴²

In the offer phase, offerors should separately account for costs created by an offset transaction so purchasing governments may more accurately assess the benefits of purchasing an offset.³⁴³ The accounting for such costs would depend on whether an offset is direct or indirect. In a direct offset providing a component for a defense item, the cost of the defense item is integral to the price of the weapon system;³⁴⁴ therefore, in order to break out an offset's true cost, a vendor would have to disclose how much the component costs when manufactured in the vendor's country, and in the purchasing

³³⁹ Code of Conduct on Offsets, *supra* note 162, at 3-4.

³⁴⁰ See UNCITRAL LEGAL GUIDE, *supra* note 99, at 72-73 (valuation of technology transfer based on a lump-sum payment, or a payment of royalties that is linked to projections of future production, sales or profits).

³⁴¹ TRANSPARENCY INT'L, DUE DILIGENCE, *supra* note 338, at 36.

³⁴² See OECD Bribery in Public Procurement, *supra* note 262, at 67 (lack of transparency in national security procurements fails to provide deterrent to corrupt activity).

³⁴³ TRANSPARENCY INT'L, DUE DILIGENCE, *supra* note 338, at 35.

³⁴⁴ See DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 5, 27 (definition of direct offset).

country. Such information constitutes proprietary data that a vendor may be unwilling to disclose, even to a foreign procuring government;³⁴⁵ however, in U.S. procurements, there is a clear trend for government to require offerors to provide increasing amounts of uncertified cost and pricing data whenever the head of a procurement activity deems it to be necessary.³⁴⁶ To promote the efficient, clean expenditure of the public fisc, more purchasing governments should adopt this U.S. rule for their offset procurements. In an indirect offset, because the offset item is unrelated to the defense item, it is a secondary purchase that may be more readily broken out as a line item cost.³⁴⁷

A rule requiring separate accounting for offset costs would require purchasing governments to create new procurement rules, and for the U.S. government to change its rules for FMS transactions. Currently, FMS rules prohibit the U.S. government from disclosing contractor proprietary data to a purchasing government without vendor authorization.³⁴⁸ The U.S. government justifies this policy by citing a perception that foreign governments do not want offset costs to be highlighted, and that U.S. defense contractors do not want offset costs disclosed because they are concerned that a foreign

³⁴⁵ Defense vendors are often not required to disclose cost and pricing data in foreign government procurements because many of these governments do not have laws, such as the Truth in Negotiations Act (TINA), which require them to do so. Marvel, *supra* note 100, at 36. In U.S. federal procurements, TINA requires contractors to provide certified cost and pricing data to the federal government if an acquisition is above a certain dollar threshold, is a negotiated procurement, and the contracting officer determines there is inadequate price competition. 10 U.S.C. § 2306a, 41 U.S.C. § 254b.

³⁴⁶ 10 U.S.C. § 2306a(c); 41 U.S.C. § 254b(c).

³⁴⁷ See DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 5, 27 (definition of indirect offset); Dumas, *supra* note 15, at 21 (offsets as providing discounts for offset items, or merely constituting secondary purchases).

³⁴⁸ In an FMS transaction, the U.S. government is prohibited from disclosing cost or pricing data to a purchasing government without the consent of the vendor. DFARS § 225.7304(c); DoD 5105.38-M, *supra* note 70, at C6.3.9.1. Proposed costs or prices constitute protected source selection information. FAR § 2.201.

government may refuse to pay for them.³⁴⁹ Such a rationale prioritizes making an FMS deal over transparency interests. However, instead of retroactively policing corruption in FMS transactions through criminal laws such as the FCPA and FCA, it would be more commendable, and consistent, for the U.S. to promote transparency in order to prevent such corruption from occurring.

Once an award decision occurs, purchasing governments should publicly disclose data on each offset recipient to maximize public awareness of how the public fisc is being spent. Such information should include the names and addresses of local offset subcontractors, the places of execution or performance, the nature of the offset products or services to be supplied, and the time limits for performance.³⁵⁰ Among their critics, offsets are often criticized as being subsidies that go to inefficient, politically connected companies instead of economically efficient businesses.³⁵¹ With the publication of information on offset recipients, the general public in a purchasing country could judge for itself whether an offset is meritorious, politically driven, or corrupt. Although the publication of the names of defense subcontractors is not required in some countries, such as the U.S., it is required as a transparency measure in the E.U.³⁵² The OECD should encourage the adoption of the E.U. rule on publicizing subcontract awards in the interest of increasing public accountability for defense offsets.

³⁴⁹ *Offsets of Foreign Military Sales: FMS Offsets and Other Issues Affecting FMS Procurements Frequently Asked Questions (FAQs)*, OFFICE OF THE UNDER SECRETARY OF DEFENSE FOR ACQUISITION, TECHNOLOGY AND LOGISTICS, http://www.acq.osd.mil/dpap/cpic/ic/offsets_of_foreign_military_sales.html#q4 (last visited Jul. 30, 2012); DoD 5105.38-M, *supra* note 70, at C6.3.9.1.

³⁵⁰ See 2009 Directive, *supra* note 71, at art. 52, Annex V (requirement for tenderers who are not contracting authorities to publish subcontract awards above a certain threshold).

³⁵¹ Taylor, *supra* note 28, at 38 (offsets as subsidies for politically favored parties); Markowski and Hall, *supra* note 54, at 49 (offsets as subsidies to support inefficient local subcontractors); Markusen, *supra* note 47, at 74 (offsets redistributing production to second-best producers in foreign countries).

³⁵² In U.S. federal contract award notifications, only the name of the prime contractor is required for publication. FAR § 5.207(a). However, this is not the case in E.U. defense procurements. 2009 Directive, *supra* note 71, at art. 52, Annex V.

2. *Valuation Proposals*

In addition to promoting transparency, the OECD should promote rules that reign in valuation practices that distort the true value of an offset proposal, and that may be exploited by corrupt officials to tip the award of offset contracts. The Code of Conduct requires E.U. Member States to value offsets at a less significant weight than other award criteria in order to assure a procurement is based on best value, and to value offset proposals at no more than the total value of the defense sales contract.³⁵³ The OECD should adopt the Code of Conduct's restriction on the maximum value of offset valuation, but it should also improve on the Code of Conduct's provisions by restricting the range of discretion government officials have in choosing offset multipliers.

The problem of offset valuation, and the corruption caused by offset over-valuation, has generated two different reform proposals. First, the Code of Conduct has promulgated regulations that prohibit total offset valuations from exceeding the value of the procurement contract, and that recommend offsets receive less weight in award decisions than other economic factors.³⁵⁴ Alternatively, TI has recommended that either offsets not be considered at all as an award criterion, or that offset award criteria should be fully transparent and given less weight than technical requirements such as cost and quality of an offer.³⁵⁵ Both of these proposals focus on the weight assigned to offsets as an award criterion. However, from an anti-corruption perspective, an offset's weight as an award criterion is not the most effective area to focus offset reform efforts. First, because offsets currently constitute such a large percentage of the value of foreign defense sales contract—in U.S. vendor contracts, for example, their value is 63.5

³⁵³ Code of Conduct on Offsets, *supra* note 162, at 4.

³⁵⁴ *Id.* at 4.

³⁵⁵ TRANSPARENCY INT'L, DUE DILIGENCE, *SUPRA* NOTE 32 (2012).

percent³⁵⁶—it is not practical to require purchasing governments to give no consideration to offsets as an award criterion. Offsets are simply too valuable to ignore. Second, Poland’s purchase of the F-16 showed that an award criterion with the small comparative weight of 15 percent, when compared to 45 percent for price and 40 percent for tactical criteria, can still be decisive when other criteria are evenly matched among bidders.³⁵⁷ Third, the weight assigned to offsets as an award criterion is not particularly susceptible to corrupt exploitation, because the weight assigned to an award criterion affects all offerors equally. Therefore, instead of focusing on the weight of offsets as an award criterion, anti-corruption advocates should focus on valuation tools that can manipulate individual offeror ratings. The tools most susceptible to individual offeror manipulation are offset multipliers, minimum value requirements, and valuation formulas.

Offset multipliers and minimum value requirements work together in a self-reinforcing spiral that distorts offset valuation. Purchasing governments often require minimum offset valuations which equal or even exceed the value of the underlying defense sale, and they express their offset demands as a percentage of the value of the defense sales contract’s price, not as an independent dollar figure.³⁵⁸ However, offsets are not a “free lunch”: defense vendors must cover offset costs by increasing the total price of a defense sales contract, or by using multipliers to achieve minimum offset requirements.³⁵⁹ Multipliers, though, are the only real means to reduce an excessive minimum offset demand, because an increase in the price of a defense sales contract will

³⁵⁶ DEP’T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 3.

³⁵⁷ See Seguin, *supra* note 36, at 11, 16, 30-31 (weight of offset, price and technical criteria in Poland’s procurement for fighter aircraft in 2002, and the final calculus that resulted in the F-16 winning the Polish procurement).

³⁵⁸ GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 1; GENERAL ACCOUNTING OFFICE, GAO/NSIAD-96-65, *supra* note 9, at 2; Eriksson, *supra* note 33, at 30.

³⁵⁹ GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 1; Brauer and Dunne, *supra* note 12, at 2.

only further increase that contract's offset requirement. Obtaining a high multiplier, then, becomes crucial for a vendor's success in a defense procurement. All offerors for a defense procurement must meet the same minimum offset requirement,³⁶⁰ but corruption may enter an offset transaction when a procurement authority has discretion on what multiplier to assign to a specific offset proposal. If a government official is able to multiply an offset proposal by a factor ranging anywhere between 10 to 30 times its actual value,³⁶¹ as is the case in one European country, it is not difficult to see the temptation for an offeror to bribe such an official to obtain a 200 percent multiplier.

The advocates for multipliers tout them as reducing the dollar burden of offset obligations, and as encouraging specific types of offset activity the purchasing government wishes to purchase.³⁶² However, this argument does not acknowledge that large multipliers make high offset dollar burdens mathematically possible. Moreover, it is not necessary for governments to encourage specific types of offset activity given the highly competitive nature of the international defense market. In a Kuwaiti procurement, for example, the government required offsets worth only 30 percent of the defense sales contract's value, yet the winning bid's offset package was worth 333 percent of the underlying contract price.³⁶³ To stay competitive in such a procurement, an offeror has no choice but to meet a purchasing government's offset demands. However, an extensive use of multipliers, when combined with broad discretion in multiplier valuation, creates a mechanism for corrupt government officials to fix offset valuations for favored offerors.

³⁶⁰ See GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 1.

³⁶¹ See DEP'T OF COMMERCE, TWELFTH STUDY, *supra* note 33, at Appendix F (multipliers in use in the Netherlands).

³⁶² GENERAL ACCOUNTING OFFICE, GAO-04-954T, *supra* note 59, at 1; Georgopoulos, *Revisiting*, *supra* note 50, at 36.

³⁶³ Redlich and Miscavage, *supra* note 34, at 387.

To remedy the corruption risk posed by multipliers and offset value requirements, the OECD should restrict their use by narrowing the discretionary range government officials have in calculating multiplier values, and by capping total offset valuation at 100 percent of the price of the defense sales contract. Government officials must have discretion in calculating the value of an offset proposal in order to determine best value among offerors, and multipliers may assist in rewarding an offset proposal delivering exceptional value. However, government officials should not have wide discretion on the range of multiplier values to assign to an offset proposal. Having the ability to multiply an offset by a factor between 10 and 30 is excessive, and seems to invite abuse.³⁶⁴ What the ideal multiplier range should be is a matter for debate, but the range should be narrow in order to limit the potential for corrupt manipulation. In regard to putting a maximum limit on offset valuations, such a limitation would further check the discretion of government officials, require multipliers to be used more selectively among offset proposals, and reduce the trend of purchasing governments to overprice and oversell the economic benefits of offset packages.³⁶⁵

3. *Competition Proposals*

In addition to efforts promoting transparency and offset valuation, the OECD should set standards that more strictly define when a purchasing government may sole source an offset to a local contractor. The Code of Conduct states that E.U. Member States will allow foreign suppliers to select the most cost effective business opportunities within a purchasing country for offset fulfillment, which will enable fair and open competition

³⁶⁴ See DEP'T OF COMMERCE, TWELFTH STUDY, *supra* note 33, at Appendix F (offset multipliers of up to 30 in the Netherlands).

³⁶⁵ See U.S. GENERAL ACCOUNTING OFFICE, GAO/NSIAD-93-184, *MILITARY SALES TO ISRAEL AND EGYPT: DOD NEEDS STRONGER CONTROLS OVER U.S.-FINANCED PROCUREMENTS 33-34 (1993)* (offset value inflation).

when it is appropriate.³⁶⁶ However, this formulation leaves an open question on when it is appropriate to enable fair and open competition, and when it is not. Specifically, the Code of Conduct is unclear on whether national security grounds may allow a Member State to sole source an offset award to a local contractor.³⁶⁷ To clarify this exception to competition, the OECD should specify that sole sourcing on national security grounds should be done only in reference to components directly related to a defense item, and that offsets indirectly related to a defense item should be awarded subject to full and open competition.

Because sole source awards may serve as the reward for a bribe, it would be ideal to place strict conditions on all sole source awards, regardless of whether they are directly or indirectly related to an offset. However, restricting sole source awards in the sphere of direct offsets is not feasible for national security and political reasons. In regard to national security, purchasing governments require direct offsets in order to mitigate the risk to their sovereignty posed by purchasing a foreign weapon system.³⁶⁸ Specifically, purchasing governments require local production and technology transfer for key weapons components in order to reduce the threat posed by disruptions to security of supply, and to retain some technological control over a defense item.³⁶⁹ Additionally,

³⁶⁶ Code of Conduct on Offsets, *supra* note 162, at 4. The Code of Conduct qualifies appropriateness by referring to efficiency, practicality, and economic or technical appropriateness. *Id.*

³⁶⁷ National security grounds are not specifically referred to in the Code of Conduct, but they are implicit given that Article 296 of the Treaty Establishing the European Community allows Member States to exempt military equipment from Community regulation. *Id.*; Consolidated Version of the Treaty Establishing the European Community art. 296, 2002 O.J. (C 325) 33, 149.

³⁶⁸ Green Paper, *supra* note 56, at 4-5 (offset requirements address security of supply and technological superiority concerns); Heuninckx, *Procurement Directive*, *supra* note 57, at 22 (threats to security of supply); BIALOS, *supra* note 29, at 5, 33 (governments traditionally procuring defense items from domestic industry to promote technological superiority of their weapons systems).

³⁶⁹ Green Paper, *supra* note 56, at 4-5 (offset requirements address security of supply and technological superiority concerns); Markowski and Hall, *supra* note 54, at 45-46 (offsets use local content

purchasing governments require sole source awards to specific companies for direct offsets in order to keep a local defense contractor solvent, or to equally spread offset work among defense contractors in the same industry.³⁷⁰ Although offset critics alleges the national security rationale has been abused to exempt defense procurements in general, and offsets in particular, from regular procurement rules, the reality is that it is very difficult to scrutinize which defense procurement sourcing decisions are in the interest of protecting national security, and which are not.³⁷¹ Such decisions are inherent to a nation's sovereignty, and are political questions not subject to judicial review.³⁷² Therefore, the issue of sole source awards for direct offsets is a non-starter. Instead, the OECD should attempt to form an international consensus for the proposition that national security concerns justify directing offset awards to companies producing a defense item and its components, and that sole source awards for indirect offsets are permissible only if otherwise allowable under a country's procurement rules.

Because indirect offsets are unrelated to a defense article or service, it may seem obvious that they are procured for economic reasons, and have no relation to national

requirements to source a portion of the contract value in the buyer's territory); Markusen, *supra* note 47, at 68 (transfer of technology as typical in offset packages).

³⁷⁰ See BIALOS, *supra* note 29, at 51 (Poland and Romania directing offset work to state-owned or controlled entities in order to keep them solvent); GENERAL ACCOUNTING OFFICE, GAO/NSIAD-99-35, *supra* note 295, at 5 (1998) (Asian government directing subcontract work to specific companies in order to spread offset work among multiple contractors in the same industry).

³⁷¹ Heuninckx, *Procurement Directive*, *supra* note 57, at 2 (E.U. Member States abusing Article 346 of the Treaty on the Functioning of the European Union to exempt their defense procurements from regular E.U. procurement rules); Eriksson, *supra* note 33, at 5 (general difficulty in justifying any offset on national security grounds); Edwards, *supra* note 56, at 3 (difficulty of defining national security interests).

³⁷² Aris Georgopoulos, *The Commission's Interpretive Communication on the Application of Article 296 EC in the Field of Defence Procurement*, P.P.L.R. 2007, 3, NA43-52, NA45; Nicolas Pourbaix, *The Future Scope of Application of Article 346 TFEU*, P.P.L.R. 2011, 1, 1-8, at 7; see also *ManTech Telecommunications and Information Sysms Corp. v. U.S.*, 49 Fed.Cl. 57, 75 at FN27 (Fed. Cl. 2001) (judicial deference is at its apogee in matter pertaining to the military and national defense, including matters pertaining to military requirements in defense procurements).

security interests or policies.³⁷³ However, this is not an obvious point in international defense trade. Defense products increasingly incorporate components designed for civilian use, such as aerospace software, into defense systems.³⁷⁴ As a result, an indirect offset performed today could potentially benefit future business in a purchasing country's defense sector. Because of this cross-pollination between certain civilian industries and the defense sector, some E.U. Member States, for example, count offsets related to civilian sectors such as aerospace as direct offsets.³⁷⁵ However, the OECD should prohibit such a loose definition of a direct offset. At the time of contract, the parties specify which components in a defense item will be locally produced, and which will not; this is the whole point of a country engaging in local content requirements.³⁷⁶ What should matter in characterizing an offset as direct or indirect is the present intent of the offset when it is entered into. Potential uses that may or may not come to fruition are too speculative to form a basis for offset characterization. By restricting sole sourcing to defense components, the OECD would prevent national security justifications from being abused to sole source offset contracts meant primarily for civilian applications.

B. *Vendor Compliance Initiatives*

In order to comply with the terms of the FCPA, Bribery Act and Anti-Bribery Convention, defense vendors must institute compliance programs that prevent criminal

³⁷³ DEP'T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 5, 27 (definition of indirect offset); Taylor, *supra* note 28, at 40 (justifications for indirect offsets).

³⁷⁴ Georgopoulos, *Revisiting*, *supra* note 50, at 33.

³⁷⁵ See Eriksson, *supra* note 33, at 16 (variation in taxonomy among E.U. Member States regarding the definition of a direct offset).

³⁷⁶ See Markowski and Hall, *supra* note 54, at 46 (local content requirements make a defense purchase conditional on an agreed upon portion of the contract being produced in the purchasing government's territory).

conduct as well as detect it.³⁷⁷ Specifically, defense vendors must make and keep accurate, reasonably detailed books and records, and maintain an adequate system of internal accounting controls.³⁷⁸ These anti-bribery statutes recognize that compliance program measures must be reasonable and in proportion to the corruption risk posed by the business relationship and transaction at issue.³⁷⁹ However, the corruption risks posed by defense offsets are among the highest in the defense sector³⁸⁰ because defense offsets meet the criteria for nearly every risk factor for corrupt activity.³⁸¹ As a result, the compliance measures put into place by a defense vendor for their offset programs must necessarily be among the highest in the defense industry. Therefore, offset compliance measures must set the standard among anticorruption compliance programs.

From the perspective of a governmental authority, in order for a corporation's compliance program to effectively deter and detect corrupt activity, and thus persuade the governmental authority to not prosecute the corporation for any misconduct of its agents, the corporation must execute a very high standard of conduct indeed. For example, a former managing director for Morgan Stanley's real estate business in China pled guilty

³⁷⁷ U.S. SENTENCING COMMISSION, SENTENCING GUIDELINES MANUAL § 8B2.1(a) (2011); Ministry of Justice, *supra* note 211, at 31; OECD Related Documents, *supra* note 205, at 31.

³⁷⁸ See 15 U.S.C. § 78m(b)(2) (1998) (FCPA recordkeeping and internal control requirements); Bribery Act, 2010, c.23, § 7 (U.K.) (liability for failure to prevent bribery); OECD Related Documents, *supra* note 205, at 30 (requirement for effective internal controls, ethics and compliance programs to prevent and detect foreign bribery).

³⁷⁹ SENTENCING COMMISSION, *supra* note 377, at §§ 8B2.1(b), 8B2.1(c); Ministry of Justice, *supra* note 211, at 27; OECD Related Documents, *supra* note 205, at 30.

³⁸⁰ See BRIAN LOUGHMAN AND SIBERY, *supra* note 40, at 297-298 (offsets singled out as one of the riskiest business practices for bribery and corruption in the aerospace and defense sector).

³⁸¹ The criteria for high corruption risk include conducting business in regions such as Central Europe and the Middle East with a perceived high level of corruption, conducting business in an industry that is high-risk for corruption due to its high transactional value and high level of interaction with government officials, and conducting business with intermediaries who must deal with politically exposed persons and prominent public officials. See Ministry of Justice, *supra* note 211, at 27 (list of most common risk factors for corruption); TRANSPARENCY INT'L, CORRUPTION PERCEPTIONS INDEX, *supra* note 45, at 6-9 (list of countries and geographical regions with high perceptions of corruption); LOUGHMAN AND SIBERY, *supra* note 40, at 296 (risks of corruption in the defense sector); Redlich and Miscavage, *supra* note 34, at 398 (extensive use of intermediaries who interact with government officials to form offset proposals).

in 2012 to violating the FCPA by conspiring to evade the company's internal accounting controls; specifically, the director transferred a multi-million dollar ownership interest in a Shanghai real estate venture to a Chinese public official.³⁸² DOJ, however, declined to prosecute Morgan Stanley for its director's criminal conduct because Morgan Stanley maintained a system of internal controls that included an internal policy prohibiting bribery, regular training on this policy, extensive due diligence on all new business partners, stringent controls on payments made to business partners, regular monitoring of transactions, and random audits of particular employees, transactions and business units.³⁸³ Due diligence and random audits, then, are among the key components of any anti-corruption compliance program. However, due diligence and random audits are not as low cost and easy to perform as creating an anti-corruption policy and conducting annual training on it. Despite the significant cost of compliance measures, defense vendors must improve their current level of compliance practice by heightening due diligence verification standards, and by executing electronic audits of offset partner documents.

1. Due Diligence Proposals

In a high risk situation such as defense offsets, vendor due diligence should include investigations of proposed business partners' financial and business backgrounds, independent verifications of information provided by potential partners in such investigations, and periodic monitoring of business partners once a business relationship

³⁸² Department of Justice, Former Morgan Stanley Managing Director Pleads Guilty for Role in Evading Internal Controls Required by FCPA, Press Release 12-534 (April 25, 2012), <http://www.justice.gov/opa/pr/2012/April/12-crm-534.html>.

³⁸³ *Id.*

is established.³⁸⁴ However, there is evidence that such practices are not common in contemporary global business, and the defense industry in particular. A recent study by Ernst & Young on contemporary compliance practice found that, internationally, only 44 percent of the sampled companies perform due diligence background checks on third parties, and when such due diligence is performed, companies mostly rely on information provided by potential partners, and do not verify information such partners provide.³⁸⁵ These practices exist despite the fact that, internationally, 39 percent of the respondents in the same report said that bribery or corrupt practices occur frequently in their countries, and that 15 percent of respondents were prepared to make cash payments to win or retain business.³⁸⁶ On an equally pessimistic note, a separate study by TI confirmed that while most defense companies do conduct initial due diligence inquiries consisting of background checks and questionnaires posed to potential business partners, these investigations on the whole do not verify the information reported by potential business partners due to the difficulty and expense of more thorough due diligence investigations.³⁸⁷

Despite the prevalence of lax due diligence practices, extensive due diligence is a necessary risk mitigation requirement for defense vendors engaging in offset business, because once vendors enter a business relationship with an offset broker or agent, it is extremely expensive, commercially and legally, for them to extricate themselves from a compromised relationship. Vendors face substantial commercial costs—such as liquidated damages, increases in offset obligation amounts, and exclusion from future

³⁸⁴ Ministry of Justice, *supra* note 211, at 28; LOUGHMAN AND SIBERY, *supra* note 40, at 166, 170-171.

³⁸⁵ ERNST & YOUNG, *supra* note 39, at 2; TRANSPARENCY INT'L, DUE DILIGENCE, *supra* note 338, at 4-5.

³⁸⁶ ERNST & YOUNG, *supra* note 39, at 2, 4.

³⁸⁷ TRANSPARENCY INT'L, DUE DILIGENCE, *supra* note 338, at 14, 18.

government procurements—it they fail to perform an offset tainted by a third party’s corruption.³⁸⁸ Moreover, the criminal liability imposed for a corruption offense is substantial; BAE Systems, for example, paid a \$400 million criminal fine to DOJ for allegations arising from its bribery scandal with the Saudi government.³⁸⁹ The additional costs created by a heightened due diligence program are substantial, but not in comparison to the costs imposed by lost business, lost reputation, legal fees, and criminal fines.

To conduct due diligence that will effectively screen potential business partners for corruption risks, defense vendors must institute a thorough, multi-step vetting procedure. First, vendors should gain a general understanding of the third party by conducting a background investigation of a party’s executives, subsidiaries and third-party intermediaries through public databases.³⁹⁰ In addition, defense vendors should review documents provided by the party such as the its anti-corruption policies, procedures, and training activities; its business statements regarding its services and billing procedures; and its responses to questionnaires about areas of concern.³⁹¹ The information gained in this initial step provides a baseline of knowledge for further inquiry, and is not the inquiry’s stopping point.

Next, vendors should conduct face-to-face interviews with key executives, business references, and government officials to verify information provided by the third party and

³⁸⁸See DEP’T OF COMMERCE, SIXTEENTH STUDY, *supra* note 9, at 3. The consequences for failing to perform an offset obligation include the cost of earning the offset credit that would have been earned by a tainted transaction.

³⁸⁹ Department of Justice, BAE Systems PLC Pleads Guilty and Ordered to Pay \$400 Million Criminal Fine, Press Release 10-209 (March 1, 2010), <http://www.justice.gov/opa/pr/2010/March/10-crm-209.html>. BAE Systems pled guilty to conspiring to defraud the U.S., making false statements about its FCPA compliance program, and violating the Arms Export Control Act and International Traffic in Arms Regulations. *Id.*

³⁹⁰ LOUGHMAN AND SIBERY, *supra* note 40, at 71, 166; Ministry of Justice, *supra* note 211, at 28.

³⁹¹ LOUGHMAN AND SIBERY, *supra* note 40, at 71, 166; Ministry of Justice, *supra* note 211, at 28.

by public databases.³⁹² Conducting such interviews in country, and preferably on a one-on-one basis, is critical to obtaining candid, reliable verification. Interviews should also include personnel who actually process business transactions, such as the finance manager, controller, and operations manager.³⁹³ By obtaining information from multiple sources, vendors are more likely to discover potential corruption risk factors.

After conducting interviews, vendors should follow up on red flags discovered in the third party's relationships or business practices. If these red flags are resolvable, and not deal breakers, defense vendors should seek to resolve the risks posed by the red flags by instituting measures that, for example, have the third party certify its compliance with the vendor's compliance program, incorporate warranties into its offset contract with the vendor, and obtain independent confirmation of offset transactions from government officials or third-party sign-off panels before receiving payment for its offset work.³⁹⁴

Finally, vendors should periodically conduct re-vetting procedures such as the ones listed above to confirm that a third party remains free of taint in its business relationships and transactions.³⁹⁵ The confirmation provided by such periodic monitoring is especially necessary for offsets that require several years to complete, and for offsets that occur in corruption-prone geographic areas.

2. Documentation And Auditing Proposals

To strike a proper balance between lowering costs during a worldwide recession and maintaining compliance with anti-corruption statutes, defense vendors should increase

³⁹² TRANSPARENCY INT'L, DUE DILIGENCE, supra note 338, at 14; LOUGHMAN AND SIBERY, supra note 40, at 167; Ministry of Justice, supra note 211, at 28.

³⁹³ LOUGHMAN AND SIBERY, supra note 40, at 170.

³⁹⁴ TRANSPARENCY INT'L, DUE DILIGENCE, supra note 338, at 16, 18-19; UNCITRAL LEGAL GUIDE, supra note 99, at 41.

³⁹⁵ TRANSPARENCY INT'L, DUE DILIGENCE, supra note 338, at 14; Ministry of Justice, supra note 211, at 31.

offset documentation requirements and institute more automated record reviews to maintain accountability over offset transactions. Specifically, defense vendors should require their business partners to provide higher levels of documentation as a prerequisite for payment, and should scan these documents with analytical software to look for irregular transactional patterns.³⁹⁶ With these measures, vendors could increase the pool of data available to look for offset red flags, and focus the inquiries of on-site, traditional audits if red flags are discovered.

When Ernst & Young researched its report on international fraud and compliance programs, it discovered that international documentation and auditing measures, just like due diligence measures, are currently being under-utilized. Specifically, Ernst & Young found that internationally only 45 percent of companies had contractual audit rights in place to monitor their business partners' anti-corruption compliance.³⁹⁷ Yet even if agents and suppliers are required to sign contracts giving their customers the right to audit them, it is questionable whether such a right to audit is practically enforceable. Traditional audits consist of site visits, interviews and transaction testing, which are expensive to set up and execute.³⁹⁸ Actually setting up an audit can take several months of negotiation, and several more in execution, and as a result conducting an auditing can be cost-prohibitive in time and money.³⁹⁹ In light of the global recession, companies throughout the world are cutting back on labor-intrusive measures such as in-person

³⁹⁶ ERNST & YOUNG, *supra* note 39, at 10 (use of analytic software); LOUGHMAN AND SIBERY, *supra* note 40, at 124 (use of transaction testing); see also UNCITRAL LEGAL GUIDE, *supra* note 99, at 41-43 (various methods to obtain documentation from business partners).

³⁹⁷ ERNST & YOUNG, *supra* note 39, at 10.

³⁹⁸ OECD Related Documents, *supra* note 205, at 31; ERNST & YOUNG, *supra* note 39, at 10.

³⁹⁹ Sarah Johnson, *Don't Trust Verify*, CFO MAGAZINE, Feb. 1, 2012 (use of audit clauses in international industry); Romero, *supra* note 123 (negotiation and expense required for audit of business partners).

audits to remain competitive.⁴⁰⁰ However, because document and accounting controls are key internal control features,⁴⁰¹ vendors must find a more cost effective means of maintaining accountability over their offsets transactions.

In order to strike a new balance between maintaining compliance and reducing compliance costs, defense vendors should require their business partners to provide multiple forms of documentation prior to payment, and should scan these documents with analytical software to detect accounting red flags.⁴⁰² If done properly, such measures will replicate the thoroughness of traditional auditing site visits, yet leverage technology to reduce compliance costs.

Thorough documentation of offset transactions is critical to prove that such transactions are legitimate, and to permit later data mining of these documents. For several decades, vendors have required offset partners to establish “evidence accounts” where they deposit copies of sales contracts, letters of credit, shipping documents, and other documentation to prove the existence of offset transactions.⁴⁰³ Once documents were deposited in these accounts, defense vendors could retrieve them to confirm the bona fides of particular offset transactions.⁴⁰⁴ For example, sales contracts and shipping documents in an evidence account could confirm whether a countertrade sale conformed with the quantity and price terms of an offset agreement, or resorted to dumping the offset product on world markets.⁴⁰⁵ However, the usefulness of evidence accounts for

⁴⁰⁰ ERNST & YOUNG, *supra* note 39, at 6.

⁴⁰¹ LOUGHMAN AND SIBERY, *supra* note 40, at 111.

⁴⁰² ERNST & YOUNG, *supra* note 39, at 10 (use of analytic software); LOUGHMAN AND SIBERY, *supra* note 40, at 124 (use of transaction testing); see also UNCITRAL LEGAL GUIDE, *supra* note 99, at 41-43 (various methods to obtain increased documentation from business partners).

⁴⁰³ UNCITRAL LEGAL GUIDE, *supra* note 99, at 43.

⁴⁰⁴ *Id.*

⁴⁰⁵ See Brauer, *supra* note 65, at 55 (dumping offset products on the world market); Markowski and Hall, *supra* note 54, at 47 (default on offset obligations).

electronic document scans has been limited because they have recorded mostly traditional sources of documentation.⁴⁰⁶ To improve the utility of evidence accounts for data mining, offset contracts could also require offset partners to deposit into an evidence account further documentation such as offset-related correspondence with government officials and commercial agents, status reports on offset progress, and inventories of offset components. If evidence accounts contained this increased level of transactional documentation and offset correspondence, there would be a sufficient variety of information to use for a thorough electronic document scan.

Once a vendor gathers its offset documentation, the vendor could scan these documents with a variety of automated tools to look for offset red flags. Analytical software tools come in three main forms: statistical analysis, text analysis, and data visualization. Statistical analysis runs numerical data through mathematical formulae in order to graph transactions and detect statistical anomalies.⁴⁰⁷ Data analysis uses keyword searches to extract words by category, theme or meaning in order to identify corrupt intent or potentially improper payments.⁴⁰⁸ Finally, data visualization integrates data from data and statistical analysis onto data visualization dashboards in order to assist analysts in detecting anomalous patterns.⁴⁰⁹ Such techniques are not perfect analytic tools; text analysis, for example, is unable to detect corrupt intent if local data privacy laws prohibit email searches without the prior consent of the sending and receiving parties, or if analysts are unfamiliar with a foreign language's idioms and nuances.⁴¹⁰

⁴⁰⁶ See UNCITRAL LEGAL GUIDE, *supra* note 99, at 43 (use of evidence accounts to deposit sales contracts, letters of credit, shipping documents, etc.).

⁴⁰⁷ LOUGHMAN AND SIBERY, *supra* note 40, at 145, 147.

⁴⁰⁸ *Id.* at 144.

⁴⁰⁹ *Id.* at 145.

⁴¹⁰ *Id.* at 151; ERNST & YOUNG, *supra* note 39, at 24.

However, these analytical tools allow defense vendors to scan more documents than would be feasible in a traditional, accountant-based review. Moreover, automated document scans allow vendors to hone in on specific red flags that could form the basis of a traditional audit or other, more intensive compliance measures. Therefore, defense vendors should increase their use of increased documentation and software analysis tools, both for their increased level of compliance oversight, as well as their potential for compliance cost savings.

VI. CONCLUSION

The unregulated state of defense offsets, combined with their many risk factors, make them especially vulnerable to corruption. Although there is currently no multinational consensus on how to regulate them, it is possible to form such a consensus if governments form a dialogue on how to effectively manage offsets. It is not enough for governments to regulate offsets through backward-looking criminal statutes such as the FCPA, Bribery Act, Anti-Bribery Convention and FCA. Offsets are government procurements, and as such governments in offset provider and recipient countries bear an affirmative duty to ensure offset acquisitions are done fairly, without corruption. However, while the defense industry waits for governments to fix offset corruption problems, defense vendors must heighten the urgency of their compliance programs. Prosecution under international anti-corruption laws poses a significant liability risk, and vendors cannot afford the reputational and monetary costs of being labeled as a corrupt defense contractor.