Aerospace and Defense Industries

Kimberly A. Strosnider, Mark J. Nackman, C.S. Maravilla, W. Hartmann Young, Steven D. Tibbets, Albert Nolette, Julie Robinson, Catherine Walsh, Michael Woods, Ana Luisa Derenusson, Sabine Schuttoff, Paulo Anger, Rachel A. Yates, Marcus F. McKindra, Poorvi Chothani, Elisabeth S. Preston, Monica Podgorny, R. Locke Bell, and Christine M. Minarich*

This article reviews international law developments in the field of aerospace and defense industries in 2012.[1]

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* Kimberly A. Strosnider of Covington & Burling LLP, Mark J. Nackman of General Dynamics Advanced Information Systems, the Hon. C. Scott Maravilla of the Federal Aviation Administration, and W. Hartmann Young of Perkins Coie LLP were the editors of the Aerospace and Defense Industries Committee's Year in Review for 2012. Steven D. Tibbets of Steese, Evans & Frankel, P.C. authored Section I on "Defense Logistics Agency's Anti-Counterfeiting Efforts: A Glimpse into Requirements U.S. Government Contractors and Their Suppliers Are Likely to Face in Light of Statutory Crackdown." Albert Nolette, Julie Robinson, Catherine Walsh, and Michael Woods of Heenan Blaikie SRL/LLP authored Section II on "Canada's New Shipbuilding Procurement Strategy." Ana Luisa Derenusson, Sabine Schuttoff, and Paulo Anger of De Luca, Derenusson, Schuttoff e Azevedo Advogados authored Section III on the "Levy of the State VAT on Operating Lease Agreements in Brazil: An Ongoing Debate." Rachel A. Yates of Holland & Hart LLP and Marcus F. McKindra, a law student at the University of Denver Sturm College of Law, authored Section IV on "Recent Developments in State Law Liability Waivers and Limitations Related to Spaceport Activities and Space Tourism." Mark J. Nackman authored Section V on "Executive Order - Strengthening Protections Against Trafficking in Persons in Federal Contracts." Poorvi Chothani authored Section VI on "India - Defence Procurement Policy - Changes in Offset Requirements." Elisabeth S. Preston and Monica Podgorny of McMillan LLP authored Section VII on "Recent Deferred Prosecution Agreement in Unlawful Export to China." R. Locke Bell, a law student at George Washington University School of Law, authored Section VIII on "Amendment to DFARS Part 231." Kimberly A. Strosnider and Christine M. Minarich of Covington & Burling LLP authored Section IX on "The U.S.-U.K. Defense Trade Cooperation Treaty." The views of the authors are not attributable to their law firms, companies, or government agencies. The article covers developments during 2012.

1. For developments in 2011, see Mark J. Nackman et al., *Aerospace and Defense Industries*, 46 Int'l Law. 287 (2012). For developments in 2010, see Mark J. Nackman et al., *Aerospace and Defense Industries*, 45 Int'l Law. 287 (2011).

I. Defense Logistics Agency's Anti-Counterfeiting Efforts: A Glimpse into Requirements U.S. Government Contractors and Their Suppliers Are Likely to Face in Light of Statutory Crackdown

The presence of counterfeit electronic components in the U.S. defense supply chain has received a great deal of attention in recent years, both within the government procurement community and among members of Congress. A recent statute directed the U.S. Department of Defense (DoD) to issue regulations establishing enhanced procedures for eliminating counterfeit parts from the defense supply chain, which the DoD is in the process of creating.[2] Meanwhile, the Defense Logistics Agency (DLA), the primary logistics combat support sub-agency within the DoD, has begun to require suppliers to use Deoxyribonucleic Acid (DNA) marking for certain high-risk electronic components.[3] The steps DLA has taken foreshadow the sorts of enhanced controls that can be expected in the future by DoD contractors and their suppliers, which are often located in countries where electronic components are manufactured more cheaply than they could be manufactured in the United States.

Section 818 of the FY 2012 National Defense Authorization Act (NDAA), enacted on December 31, 2011, requires the DoD to issue regulations that define counterfeit parts, detect and prevent their entry into the defense procurement supply chain, and establish reporting requirements for any actual or suspected counterfeit parts that make their way into the supply chain.[4] Section 818 further directs the U.S. Department of Homeland Security to adopt processes for detecting counterfeit electronic parts as they are imported.[5] Defense contractors and their suppliers should expect new regulations imposing requirements designed to eliminate counterfeit parts in 2013.

Not content to wait for the adoption of DoD-wide rules, DLA has established a new clause to be incorporated into contracts for the purchase of electronic components falling within Federal Supply Class 5962, which applies to "Electronic Microcircuits."[6] The clause requires contractors to "provide items that have been marked with botanically-generated DNA marking material produced by Applied DNA Sciences (ADNAS) or its authorized licensees, if any."[7] DNA may be mixed with ink used to mark the microcircuit or invisibly placed on the microcircuit via another method, and the DNA must be unique to the contractor.[8] Thus, contractors that wish to sell electronic microcircuits to DLA—or suppliers that wish to sell microcircuits to those contractors—must pay close attention to solicitations and be prepared to use DNA marking if the key clause appears in them.

DLA's example offers a preview of the type of anti-counterfeiting measures defense contractors and their suppliers can expect to face. Commenters have opined that contrac-

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2. National Defense Authorization Act for Fiscal Year 2012, Pub. L. No. 112-81, § 818(b)-(c), 125 Stat. 1298, 1493-95 (2011).

3. Press Release, Def. Logistics Agency, Defense Logistics Agency Requires DNA Marking to Combat Counterfeiting (Oct. 31, 2012), http://www.dla.mil/DLA_Media_Center/PressRelease/Pages/pressrelease 1211271406.aspx.

4. § 818(b)-(c).

5. *Id.* § 818(d).

6. DEF. LOGISTICS AGENCY, DEFENSE LOGISTICS ACQUISITION DIRECTIVE REVISION 5, subpt. 11.304-93(e) (2012), *available at* http://www.dla.mil/Acquisition/Documents/DLAD%20Rev%205.pdf.

7. *Id.* § 52.211-9074(b).

8. *Id.*

tors will seek to "flow down" requirements, and their attendant costs, to suppliers; that contractors will face additional engineering and manufacturing costs; and that the limited numbers of suppliers willing to shoulder the burdens of anti-counterfeiting measures will lead to increased prices for components sold to the DoD and other U.S. Government agencies.[9] Commenters have further noted difficulties in attempting to remedy the problem simply by imposing requirements on contractors and their suppliers: "Contributing causes to counterfeit parts, such as parts obsolescence, the globalization and commercialization of the supply chain, and the contraction of a specialized defense electronics supply base, are outside the authority or responsibility of defense system contractors."[10] Thus, the aerospace and defense industries should anticipate increased compliance burdens associated with electronic components—such as DLA's new DNA marking requirement. Whether new regulations are effective in eliminating counterfeit parts from the defense supply chain remains to be seen as DoD develops rules to carry out section 818 of the NDAA.

II. Canada's New Shipbuilding Procurement Strategy

One of the most important recent developments in the context of North American defense planning and spending is the Government of Canada's plan to renew its naval fleet over the next three decades. The National Shipbuilding Procurement Strategy (NSPS) is a multi-billion-dollar initiative that represents the largest procurement sourcing arrangement in Canadian history.[11] The strategy has three main components:

- Two packages to build large vessels (both combat and non-combat) through strategic long-term partnerships with two shipyards, valued at CAD $33 billion;[12]
- Small vessel construction of over 100 ships for shipyards not selected for the large vessel build, valued at CAD $2 billion and made available through competitive procurement;[13] and
- Ongoing regular repair and maintenance, valued at CAD $500 million annually and made available through normal procurement processes.[14]

The aim of the NSPS is to renew the Royal Canadian Navy and the Canadian Coast Guard fleets and ensure operational continuity in the Atlantic, Pacific, Arctic, and beyond. The NSPS will create regional and industrial benefits, sometimes referred to as offsets, and general significant economic benefits in shipbuilding and related Canadian companies. Potential suppliers should therefore be aware of both the opportunities and the spe-

9. AM. BAR ASS'N SECTION OF PUB. CONTRACT LAW, A WHITE PAPER REGARDING DEPARTMENT OF DEFENSE IMPLEMENTATION OF SECTION 818 OF THE NATIONAL DEFENSE AUTHORIZATION ACT FOR FISCAL YEAR 2012, at 12 (2012), *available at* http://www.americanbar.org/content/dam/aba/administrative/public_contract_law/aba_pcl_taskforce_on_counterfeit_part_white_paper.authcheckdam.pdf.

10. Jeffrey M. Chiow & Robert S. Metzger, *Legislating Supply Chain Assurance: An Examination of Section 818 of the FY 2012 NDAA*, 47 PROCUREMENT LAW. 4, 27 (2012).

11. *The National Shipbuilding Procurement Strategy*, PRIME MINISTER CAN. (Jan. 12, 2012), http://pm.gc.ca/eng/media.asp?id=4575.

12. *The National Shipbuilding Procurement Strategy*, CAN. ECON. ACTION PLAN, http://actionplan.gc.ca/en/page/national-shipbuilding-procurement-strategy (last visited Feb. 1, 2013) [hereinafter ACTION PLAN].

13. *The National Shipbuilding Procurement Strategy*, *supra* note 11.

14. *Id.*

cific requirements created under NSPS to properly prepare supplier or sub-contractor bids.

Two shipbuilders were selected in 2011 as Canada's strategic sources of supply for the construction of twenty-eight large vessels over the next twenty to thirty years.[15] Irving Shipbuilding Inc. was awarded the contract to build twenty-one combat vessels and Vancouver Shipyards Co. Ltd. was awarded the contract to construct seven non-combat vessels.[16] Umbrella Agreements were signed with the two shipyards in February 2012. The first of the individual shipbuilding contracts was announced July 10, 2012 as part of the Arctic Offshore Patrol ships project.[17]

Suppliers and subcontractors will play important roles in the NSPS given the equipment needs, expertise, and high-technology requirements of the projects. In fact, the Government of Canada "estimated that over half of the value of the shipbuilding contracts could flow to the broader marine industry."[18] Irving and Vancouver Shipyards will select suppliers that are aligned with the NSPS objectives and enable them to meet their Industrial and Regional Benefits (IRB) commitments.[19]

As a result of the IRB policy, prime contractors such as Irving are also obligated to pass along their IRB obligations to their tier one suppliers and when they subcontract to U.S. companies wishing to pursue business in the context of NSPS. Any prospective subcontractor or supplier should expect IRBs to be a mandatory element within a subcontract issued by prime contractors such as Irving.

Canada's NSPS promises to create significant opportunities for North America firms that are able to navigate through the specific requirements that are part of the defense procurement process (e.g., IRBs export control, tendering process, etc.). Canadian, U.S., and other defense suppliers are expected to mount major efforts in pursuit of projects in this multi-billion-dollar procurement, as well as in the myriad subcontracting opportunities in all aspects of the procurement.

III. Levy of the State VAT on Operating Lease Agreements in Brazil: An Ongoing Debate

A debate has been underway in Brazil, continuing in 2012, regarding the levy of the State Value Added Tax (local acronym ICMS) on operating lease agreements executed with Brazilian airlines. Under these agreements, aircraft, spare parts, components, or

15. *Backgrounder: NSPS Update - October 2012*, PUB. WORKS & GOV. SERVS. CAN., http://www.tpsgc-pwgsc.gc.ca/app-acq/sam-mps/fiche-backgrounder-eng.html (last modified Oct. 18, 2012).

16. *Results of the National Shipbuilding Procurement Strategy*, CAN. NEWS CENTRE (Oct. 19, 2011), http://news.gc.ca/web/article-eng.do?nid=629989.

17. *Preliminary Contract Signed with Irving Shipbuilding for Arctic Offshore Patrol Ships*, CAN. NEWS CENTRE (July 10, 2012), http://nouvelles.gc.ca/web/article-eng.do?mthd=advSrch&crtr.page=1&nid=685459&crtr.kw=AOPS.

18. *Backgrounder National Shipbuilding Procurement Strategy—Economic Benefits*, PUB. WORKS & GOV. SERVS. CAN., http://www.tpsgc-pwgsc.gc.ca/app-acq/sam-mps/ddi-bkgr-5-eng.html (last modified Aug. 14, 2012).

19. The IRB "[p]olicy requires that companies that win defence and security contracts with the Government of Canada place business activities in Canada at the same value of the contract." *Industrial and Regional Benefits*, INDUS. CAN., http://www.ic.gc.ca/eic/site/042.nsf/eng/home (last modified Jan. 21, 2013).

equipment are leased to enable operations; the agreements involve no property transfer. Because of the ongoing debate, many companies still have doubts on how to proceed.

A. State Value Added Tax – An Introduction

The State Value Added Tax[20] is a tax established by Article 155, II of the Constitution of the Federative Republic of Brazil (Brazilian Constitution).[21] Article 155, II of the Brazilian Constitution establishes that the states and the Federal District have the power to institute such tax. Institution of the tax is subject to a Senate Resolution and other provisions and conditions set forth in paragraph 2 of Article 155, and by those set forth by Complementary Law No. 87. The State Value Added Tax (State VAT) concept is that the tax should be levied on the circulation of goods and services of interstate and inter-municipal transportation and communication.

B. Aircraft Operating Lease Agreements

Aircraft leasing is a common practice among Brazilian airlines. This allows companies to reduce investment costs to enable formation of their fleet, without the capital outlay. Generally, Brazilian airlines enter into operating lease agreements, importing aircraft into Brazil on a temporary basis, so that the aircraft only stays in the country during the lease term. At the end of the lease term, the lessee can choose whether to extend the term of the lease of aircraft or to return it. There is no title transfer, and the operating lease agreements contain no provision on the option to purchase the aircraft. Consequently, a debate exists on whether the State VAT should be levied on lease operations.

C. The Debate over Amendment to the Constitution Number 33/2001

One of the reasons for this debate is the Amendment to the Constitution number 33/2001.[22] After the Amendment entered into force, the State VAT was levied on the entry of goods or products imported from abroad by an individual or legal entity, regardless of

20. Imposto sobre Operações relativas à Circulação de Mercadorias e sobre Prestações de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação. [Transactions Tax on Circulation of Goods and Supply of Services Interstate and Intermunicipal Transportation and Communication], *ICMS – Aspectos Gerais* [*General Aspects*], Portal Tributário [Tax Portal], http://www.portaltributario.com.br/guia/icms.html (last visited Jan. 30, 2013).

21. Article 155 of the Brazilian Constitution provides: "The [S]tates and the Federal District shall have the competence to institute taxes on: . . . II – transactions relating to the circulation of goods and to the rendering of interstate and intermunicipal transportation services and services of communication, even when such transactions and renderings begin abroad." Constituição Federal [C.F.] [Constitution] art. 155 (Braz.).

22. Amendment to the Constitution no. 33, 2001 states: "The Directing Boards of the Chamber of Deputies and of the Federal Senate, under the terms of paragraph 3 of article 60 of the Federal Constitution, promulgate the following Amendment to the constitutional text: . . . Article 2. Article 155 of the Federal Constitution shall henceforth be in force with the following alterations: "Article 155 . . . Paragraph 2 . . . IX . . . (a) on the entry of goods or products imported from abroad by an individual or corporate body, even in the case of a taxpayer who does not pay such tax on a regular basis, regardless of its purpose, as well as on services rendered abroad, and the tax shall be attributed to the state where the domicile or the establishment of the recipient of the product, good, or service is located . . . ." Constituição Federal [C.F.] [Constitution] amend. 33 (Braz.).

its purpose. Under this provision, the State Tax Authorities charged the State VAT on operating lease agreements because the leased aircraft is imported from abroad.

Two legal theories emerged on whether or not the State VAT should be levied on operating lease agreements. The first asserts that the State VAT should be levied because the taxable event was the entry of the foreign good/product in the country. The second asserts the State VAT should not be levied on operating lease agreements because there is no transfer of ownership, and, in this respect, operating lease agreements contain no specific clause allowing the lessee to purchase the leased aircraft. This second theory is based on the position that the taxable event should take into account the concept of State VAT described in Article 155, II, which is the circulation of goods.

Many jurists defend this second theory, highlighting that the term "circulation of goods" means an actual transfer of ownership of the good or product. If the taxable event is only the entry of imported goods or products, a new import duty is being created, disregarding the fundamental concept/nature of the State VAT (which is the circulation of goods), and violating the Constitution (because the States would be imposing an import duty, which is a power vested in the Federal Tax Authorities).[23]

D. Leading Case

The levy of VAT on operating lease agreements has been extensively discussed in the Courts. The major decision related to the subject is the Extraordinary Appeal No. 461.968-7, which was decided on May 30, 2007 by the Brazilian Federal Supreme Court, and involved the levy of the State VAT on the entry of imported goods through operating leases.[24] This issue was submitted to the Federal Supreme Court sitting en banc (Sessão Plenária),[25] which decided that the circulation of goods is a prerequisite for the levy of State VAT.[26] The Supreme Court stated that "circulation of goods" means the transfer of ownership. As there is no option of transfer of ownership in aircraft operating leases, there is no "circulation of goods." Therefore, no State VAT can be levied on such agreements.[27]

E. Applicability of the Decision and Future Actions

The decision reached by the Supreme Court of Brazil is a significant precedent. But this decision does not bind the State Tax Authorities, which may (or may not) charge State VAT on operating lease agreements. The required future step is to amend the law in order to declare that no State VAT can be levied on operating lease agreements. The State of Minas Gerais, for example, has clearly stated that no State VAT is levied on operating lease agreements. In the meantime, if a company wishes to avoid the payment of

23. Article 153 of the Brazilian Constitution states: "The Union shall have the power to institute taxes on . . . importation of foreign products . . . ." Constituição Federal [C.F.] [Constitution] art. 153 (Braz.).

24. S.T.F., No. 2286-14, Relator: Min. Eros Grau, 23.08.2007, 56, Diário da Justiça [D.J.], 24.08.2007, 2713 (Braz.), *available at* http://redir.stf.jus.br/paginadorpub/paginador.jsp?docTP=AC&docID=482098.

25. *See id.*

26. *See id.* at 2716-19, 2726-30 (presenting the individual opinions of Ministros Eros Grau, Ricardo Lewandowski, Joaquim Barbosa, Carlos Britto, and Marco Aurélio of the Supremo Tribubal Federal [Supreme Court]).

27. *Id.*

State VAT under its operating lease agreements, the recommended legal action is to file a Writ of Mandamus (*Mandado de Segurança)* in the State Court.[28]

IV. Recent Developments in State Law Liability Waivers and Limitations Related to Spaceport Activities and Space Tourism

Non-governmental spaceflight companies now have limited liability protections in six U.S. states: Virginia, Florida, New Mexico, Texas, Colorado, and California.[29] Of these, Colorado and California promulgated the protective legislation in 2012. Across the six states, the legislation is fundamentally similar; however, the states differ on the types of exceptions that preclude otherwise qualified liability protections. While space travel has traditionally been a topic for futuristic science fiction, the efforts of well-funded companies, accompanied by supportive legislation, reveal the future is at hand.

As companies developed the technologies to make space tourism increasingly accessible, Congress enacted the Commercial Space Launch Amendment Act of 2004 (CSLAA) to establish the framework for licensing, safety, and insurance.[30] The CSLAA requires companies to inform participants of the risks of spaceflight as a precondition to license or permit.[31] Each company must have participants sign a waiver indemnifying the federal government from all liability.[32]

The waiver, however, only protects the federal government, leaving companies responsible for mishaps, absent contractual agreements stating otherwise. To fill the gap in liability protection under the federal scheme, state legislatures recently have extended liability protections to spaceflight companies.

This year's enactment of spaceflight liability legislation by Colorado and California marks a significant development for the space tourism industry. On April 19, 2012, Colorado enacted its Limited Liability for Spaceflight Activities Act[33] to become the fifth state to extend qualified liability protections to companies. Colorado joined Florida and New Mexico by incorporating a three-exception scheme into its legislation that limits liability protections. The Colorado General Assembly expressed its support of spaceflight activities and acknowledged that companies should reasonably expect certain protections from risks inherent to spaceflight.[34] Most recently, California enacted its Spaceflight Liability & Immunity Act on September 21, 2012.[35] California also incorporated three exceptions.

28. *See* CONSTITUIÇÃO FEDERAL [C.F.] [CONSTITUTION] art. 5(LXIX), (LXX) (Braz.).

29. Jack Kennedy, *California Sixth State to Adopt Informed Consent Human Spaceflight Regime*, SPACEPORTS (Sept. 21, 2012, 12:59 PM), http://spaceports.blogspot.com/2012/09/california-sixth-state-to-adopt.html.

30. *See* Commercial Space Launch Amendments Act of 2004, 49 U.S.C. § 70101 (2006).

31. 51 U.S.C. § 50914(b) (2006).

32. The required disclosure includes: "the safety record of the launch or reentry vehicle" and "that the United States Government has not certified the launch vehicle . . . as safe for carrying crew or space flight participants." Further, "each space flight participant must then provide consent in writing" and the entity must comply with FAA regulations. 14 C.F.R. § 460.45(a)-(b), (f) (2012).

33. *See* Limited Liability for Spaceflight Activities Act, COLO. REV. STAT. § 41-6-101 (2012).

34. *See* S.B. 12-035, 68th Gen. Assemb., 2d Reg. Sess. (Colo. 2012).

35. *See* Assemb. B. 2243, 2011-2012 Reg. Sess. (Cal. 2012).

Six state legislatures have now statutorily addressed the liability concern. As a threshold matter, all six states extend liability protections to companies.[36] Each state, in similar fashion, stipulates that a company "is not liable for injury to or death of a participant resulting from the inherent risks of spaceflight activities so long as the warning[37] . . . is distributed and signed as required."[38] All six states limit protections for a company that: (1) engages in gross negligence or willful or wanton disregard for participant safety, which proximately causes injury, damage, or death, to the participant;[39] or (2) intentionally injures the participant.[40] Florida, New Mexico, Colorado, and California have additionally denied liability protections for: (3) companies having "actual knowledge or [who] reasonably should have known of a dangerous condition on the land or in the facilities or equipment used in the spaceflight activities and the danger proximately causes injury, damage, or death to the participant . . . ."[41]

The lack of uniformity among state laws might encourage spaceflight entities to conduct their activities in the jurisdiction with the greatest perceived protection. If the laws have the intended effect of stimulating spaceflight activities in states that offer the greatest protection, harmonization among jurisdictions is more likely over time. Notably, however, New Mexico's attempt to convert to a two-exception state in 2012 was unsuccessful.[42] Nonetheless, the recent legislative developments of Colorado and California mark the continued advancement of the space tourism industry in 2012.

V. Executive Order - Strengthening Protections Against Trafficking In Persons In Federal Contracts

On September 25, 2012, the President of the United States issued an Executive Order (EO) seeking to "strengthen protections against trafficking in persons in Federal contracting" by ordering the Federal Acquisition Regulation (FAR) Council to coordinate

36. To whom these protections extend varies by state. In Virginia, Colorado, and Texas, at a minimum the FAA licensee and any manufacturer or supplier of components, services, or vehicles are protected. *See* COLO. REV. STAT. § 41-6-101(1)(b); TEX. CIV. PRAC. & REM. CODE ANN. § 100A.001(4) (West 2011); VA. CODE ANN. § 8.01-227.8 (2007). Florida, California, and New Mexico do not extend these protections to manufacturers or suppliers. But the New Mexico legislature is seeking to extend protections to manufacturers or suppliers during its 2013 legislative session. *See* H.B. 49, 51st Leg., 1st Sess. (N.M. 2013).

37. Representative warning statement: "[T]here is no liability for any loss, damage, injury to, or death of a . . . participant in a spaceflight activity provided by a[n] . . . entity if such loss, damage, injury, or death results from the inherent risks of the spaceflight activity to the . . . participant. Injuries caused by the inherent risks of spaceflight activities may include, among others, death or injury to person or property. I, the undersigned . . . participant, assume the inherent risk of participating in this spaceflight activity." Limited Liability for Spaceflight Activities Act, COLO. REV. STAT. § 41-6-101 (2012).

38. FLA. STAT. § 331.501 (2011) (demonstrating language used by all six states).

39. *See* CAL. CIV. CODE § 2212(c) (West 2012); COLO. REV. STAT. § 41-6-101(2)(b) (2012); FLA. STAT. § 331.501(2)(b) (2011); N.M. STAT. ANN. § 41-14-3(B)(1) (2010); TEX. CIV. PRAC. & REM. CODE ANN. § 100A.002(b); VA. CODE ANN. § 8.01-227.9(B) (2007).

40. *See* CAL. CIV. § 2212(c)(2); COLO. REV. STAT. § 41-6-101(2)(b)(III); FLA. STAT. § 331.501(2)(b)(3); N.M. STAT. ANN. § 41-14-3(B)(3); TEX. CIV. PRAC. & REM. CODE ANN. § 100A.002(b)(2); VA. CODE ANN. § 8.01-227.9(B)(2).

41. FLA. STAT. § 331.501(2)(b)(2); *accord* CAL. CIV. § 2212(c)(3); COLO. REV. STAT. § 41-6-101(2)(b)(II); N.M. STAT. ANN. § 41-14-3(B)(2); *cf.* TEX. CIV. PRAC. & REM. CODE ANN. § 100A.002(b); VA. CODE ANN. § 8.01-227.9(B).

42. *See* H.B. 239, 50th Leg., 2d Sess. (N.M. 2012).

with relevant agencies to amend the FAR.[43] The EO requires these steps be taken within 180 days.[44]

The United States already had a "zero tolerance policy regarding trafficking in persons."[45] But several recent reports indicate compliance remains an issue, including a Congressional Research Service Report published one day before the EO, highlighting problems at the subcontractor and recruiter levels.[46] The EO will drive change in several areas, including the creation of "improved safeguards," a requirement for contractors to "cooperate fully," and new compliance plan requirements for contracts and subcontracts "performed outside the United States [in excess of] US $500,000."[47]

The "improved safeguards" will come in the form of new express prohibitions against: (1) "using misleading or fraudulent recruitment practices;" (2) "charging employees recruitment fees;" (3) "destroying, concealing, confiscating, or otherwise denying access . . . to [an] employee's ident[ification] documents;" and (4) "failing to pay return transportation costs upon the end of employment" for third-country nationals employed outside the United States.[48]

The requirement to "cooperate fully" will oblige contractors and subcontractors to contractually agree to provide "reasonable access" to contracting and enforcement agencies during audits, investigations, and the like,[49] in addition to existing requirements to report any information alleging a violation of the U.S. Government's "zero tolerance" policy.[50] The EO also mandates creation of obligations for contracting officers to report to their agency's Inspector General, suspension and debarment official, and law enforcement, "if they become aware of any activities that would justify termination . . . or are inconsistent with the requirements of this" EO or any other law or regulation concerned with human trafficking.[51]

The new compliance plan requirements will cover "contracts and subcontracts, where the estimated value of the supplies acquired or services required to be performed outside the United States exceeds US $500,000," except those "for commercially available off-the-shelf items."[52] These new contractor compliance plans will need to be tailored "for the size and complexity of the contract or subcontract and the nature and scope of the activities performed."[53] They will "at a minimum, include": (1) "an awareness program to inform employees" of anti-trafficking in persons policies; (2) defined conduct and disciplinary standards; (3) "a process for employees to report, without fear of retaliation;" (4) "a

43. Exec. Order No. 13,627, 77 Fed. Reg. 60,029, 60,029 (Oct. 2, 2012) [hereinafter E.O. 13,627].

44. *Id.*

45. 48 C.F.R. § 22.1703 (2012).

46. LIANA SUN WYLER, CONG. RESEARCH SERV., R42497, TRAFFICKING IN PERSONS: INTERNATIONAL DIMENSIONS AND FOREIGN POLICY ISSUES FOR CONGRESS (2012); *see also* YALE LAW SCH. & AM. CIVIL LIBERTIES UNION, VICTIMS OF COMPLACENCY: THE ONGOING TRAFFICKING AND ABUSE OF THIRD COUNTRY NATIONALS BY U.S. GOVERNMENT CONTRACTORS 5 (2012) (discussing an incident of human trafficking committed by U.S. contractors).

47. E.O. 13,627, *supra* note 43.

48. *Id.* at 60,029-30.

49. *Id.* at 60,030.

50. 48 C.F.R. § 52.222-50(d) (2012).

51. E.O. 13,627, *supra* note 43, at 60,030.

52. *Id.* at 60,030-31.

53. *Id.* at 60,031.

recruitment and wage plan that" requires properly trained recruiters and prohibits recruiting violations like employee-paid recruiting fees and wages that are below host country legal requirements; (5) a housing plan that "meets host country housing and safety standards;" and (6) procedures to ensure subcontractor compliance.[54] The compliance plan changes will also drive new certification requirements.[55]

The EO also sets in motion new compliance efforts for which the U.S. Government will have responsibility, as well as new guidance to come from the Office of Federal Procurement Policy of the Office of Management and Budget.[56] These new requirements have yet to be codified in the FAR, and there is always potential for the final rules to go beyond the minimum requirements of the EO. Contractors should look for the release of a proposed or potentially final rule as early as March 2013.[57]

VI. India—Defence Procurement Policy - Changes in Offset Requirements

The Indian Ministry of Defence (MOD) announced its revised Defence Offset Guidelines effective August 1, 2012 (the New Offset Guidelines or NOG).[58] The MOD has, for the first time, specified the objectives of the Defence Procurement Policy (DPP). The objectives are three-fold: (1) fostering an internationally competitive domestic industry; (2) enhancing indigenous defense research and development and building capacity; and (3) fostering a dual-use industrial base.[59]

The New Offset Guidelines

> stipulate a minimum 30 per cent offset in 'Buy (Global)' and 'Buy and Make with Transfer of Technology (ToT)' contracts valued [at] Rs 300 crore (approximately US $55 million) . . . [T]he [NOG] clarifie[s] that an Indian company or its joint venture participating in 'Buy (Global)' contracts are exempted from offset obligations, provided the product in question has indigenous content of [a] minimum 50 per cent by value. In case the indigenous content is below 50 per cent, offsets are mandatory [for the portion that] involves foreign component[s].[60]

The NOG explicitly excludes "services" for the purpose of estimating "value addition in India," clarifying what was previously ambiguous.[61]

Under the NOG, the offset obligations can be fulfilled by investment "in kind" in specific Indian industry or designated government bodies, or by specific technology transfer to the Defence Research and Development Organisation (DRDO).[62] "As per the . . . [NOG], the investment 'in kind' is allowed in the form of [transfer of technology] or

54. *Id.*

55. *Id.*

56. *Id.* at 60,031.

57. *Id.* at 60,029.

58. *See* Press Release, Ministry of Defence, Revised Defence Offset Guidelines (Aug. 2, 2012), http://pib.nic.in/newsite/erelease.aspx?relid=85665. This section draws heavily from these guidelines.

59. *Id.*

60. Laxman Kumar Behera, *India's Defence Offset Guidelines 2012*, DEFENCE REVIEW ASIA (Sept. 13, 2012), http://www.defencereviewasia.com/articles/180/India-s-Defence-Offset-Guidelines-2012.

61. *Id.*

62. *Id.*

transfer of equipment for manufacture and/or maintenance of permitted items."[63] The transfer of technology can be through equity or non-equity options while transfer of equipment can only be by way of non-equity contributions. "In case the foreign original equipment manufacturers (OEMs) choose technology transfer as an option for discharge of offset[ ] obligations," it is mandatory that such transfer is not subject to license fees or restrictions on domestic production, sale, or export, and should be a comprehensive transfer that includes

> [A]ll documentation, training, and consultancy . . . . [T]he cost of infrastructure and [civil] equipment . . . [however,] are excluded . . . from [the] calculation of offset obligations . . . . In case of [Transfer of Equipment], ... [t]he vendors are permitted to claim credits for the entire value of equipment[ ] they transfer to their Indian offset partner. This . . . however, [is] subject to . . . [the] OEM's minimum buy-back of 40 per cent of permitted items.[64]

The NOG also contains certain multiplier incentives when the offset obligations are through certain entities that are recognized as Micro, Small, and Medium Enterprises (MSMEs), or through technology acquisition by the DRDO. The NOG provides that credit for banked offsets (except in certain cases) would now be valid for a period of seven years. It is important to note that banked offset credits cannot be used for more than 50 percent of total offset liabilities arising out of any single future contract.[65]

To monitor and enforce the offset policy, the MOD has created the Defence Offset Management Wing (DOMW). The DOMW will be one of the repositories of the signed offset contracts that will enable it to track offset obligations and implementation. The DOMW is also required to submit an annual report in June every year to the Defence Acquisition Council on the status of the implementation of all ongoing offset contracts during the previous financial year.[66] "While the [NOG] has kept the annual penalty in case of default on the part of a vendor at [5 percent], it has now mandated that the overall penalties can not exceed 20 [percent] of the total offset obligations during the main procurement contract."[67] But there is "no cap on penalt[ies] in case of default during the extended period."[68]

The NOG also "expanded the list of eligible products/services against which offsets can be discharged."[69] "The list of eligible products and services has been mainly expanded in the renamed category of 'Products for Inland/Coastal Security,'" and in the "'Civil Aerospace Products' and Service's," and Defence Products categor[ies]."[70] The NOG does not have a comprehensive list of qualified government institutions that can receive offsets in the form of Technology Transfer or Equipment but provides that these include DRDO laboratories, Army Base Workshops, Air Force Base Repair Depots, and Naval Dockyards. The NOG has also extended the period during which offset obligations have to be dis-

63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.*

charged. They can now be fulfilled within two years after the term of the main procurement contract.[71]

VII. Recent Deferred Prosecution Agreement in Unlawful Export to China

Pratt & Whitney Canada Corporation (PWC), a Canadian aircraft engine manufacturer wholly owned by United Technologies Corporation (UTC), a U.S. aerospace defense corporation, pled guilty on June 28, 2012 to violating the Arms Export Control Act (AECA),[72] and making false and untimely disclosures concerning its illegal export to China of U.S.-origin military software used in the development of China's first modern military attack helicopter, the Z-10.[73] According to the U.S. Justice Department, "[s]ince 1989, the United States has imposed a prohibition upon the export to China of all U.S. defense articles and associated technical data."[74] Additionally, "China [has] sought to develop a military attack helicopter" since the 1980s, and has "developed the Z-10 under the guise of a civilian medium helicopter program in order to secure Western assistance," namely from PWC.[75] As part of the settlement with the U.S. Justice and State Departments, UTC, its wholly owned subsidiary Hamilton Sundstrand Corporation (HSC), and PWC have agreed to pay more than US $75 million and entered into a Deferred Prosecution Agreement.[76]

The UTC entities pled guilty to the following charges:

1. "PWC [pled guilty to] knowingly and willfully caus[ing] Hamilton Sundstrand Corporation ("HSC") to export from the United States" to China "defense articles, that is . . . software to test and operate [engines] . . . used in the development of a Chinese Z-10 military attack helicopter, without having first obtained . . . a [U.S.] license or written authorization for such exports,"[77] thereby violating the AECA,[78] a U.S. criminal statute,[79] and the International Traffic in Arms Regulations, a defense trade controls regulatory regime.[80]
2. UTC entities pled guilty to making the following false statements in disclosures to the U.S. government[81]: (a) "that the . . . Z-10 . . . program was first represented to

71. *Id.*

72. Arms Export Control Act (AECA), 22 U.S.C. § 2778 (2006).

73. Michael S. Schmidt, *Military Contractors Are Fined Over Aid to China*, N.Y. TIMES, June 29, 2012, at B3.

74. Press Release, U.S. Dep't of Justice, United Technologies Subsidiary Pleads Guilty to Criminal Charges for Helping China Develop New Attack Helicopter, (June 28, 2012), http://www.fbi.gov/newhaven/press-releases/2012/united-technologies-subsidiary-pleads-guilty-to-criminal-charges-for-helping-china-develop-new-attack-helicopter.

75. *Id.*

76. Press Release, U.S. Immigration & Customs Enforcement, Deferred Prosecution Agreement 1, 10 (June 28, 2012), http://www.ice.gov/doclib/news/releases/2012/120628bridgeport2.pdf [hereinafter ICE Agreement].

77. Letter from David B. Fein, U.S. Att'y, U.S. Dep't of Justice, to James T. Cowdery, Att'y for Pratt & Whitney Canada, Cowdery, Ecker & Murphy L.L.C. 1 (June 28, 2012), http://www.ice.gov/doclib/news/releases/2012/120628bridgeport3.pdf.

78. 22 U.S.C. § 2778(b)(2), (c) (2006).

79. *Cf.* 18 U.S.C § 2 (2006) (discussing how those who aid or abet those who violate U.S. law are treated as principals).

80. *See* 22 C.F.R. §§ 127.1(a), 127.3 (2011).

81. *See* 18 U.S.C. § 1001 (2006).

PWC as a dual-use helicopter . . . where [the] civil and military applications would be developed in parallel;" and (b) "that PWC only learned several years into the project that the military version . . . was the lead version . . . when . . . engineers [went to] China and [surprisingly] saw the Z10 attack helicopter prototype [while PWC] personnel knew, [since] the project's inception in 2000, that the Z-10 program involved a military helicopter."[82]

PWC and HSC pled guilty to willingly and knowingly failing to timely inform the State Department's Directorate of Defense Trade Controls (DDTC) of an actual sale and transfer to a country with which the United States has an arms embargo, while knowing that the transfer was done without a license or written authorization for such exports.[83]

The Deferred Prosecution Agreement is in effect for a period of two years from the filing date of the Information (Deferral Period). If the UTC entities fully comply with the Agreement, the Office will file a motion with the Court seeking dismissal with prejudice of Count Two against UTC and HSC and Count Three against PWC and HSC within 30 days after the Deferral Period.[84]

VIII. Amendment to DFARS Part 231

On January 30, 2012, the DoD issued a final rule to the DFARS requiring major contractors to report online their annual costs for independent research and development (IR&D) projects.[85] Contractors must now report expenses to the Defense Technical Information Center (DTIC) using an online input method upon a project's completion and at least annually while the project is being performed.[86] Costs will be deemed expressly unallowable if they are not reported online in a timely manner.[87]

DoD is implementing the rule in an effort to increase communications between contractor personnel and agency officials.[88] By having a more detailed and organized compilation of evolving technologies in the private sector, DoD officials hope to be able to make more informed purchasing and fund allocation decisions.[89] The reporting requirement also will be used as a means of monitoring IR&D projects to ensure funds are being used to explore areas of interest to DoD.[90]

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82. Letter from David B. Fein, *supra* note 77, at 2.

83. *See* 22 U.S.C. § 2778(c) (2006) (describing punishment for criminal violations under the statute); *see also* 22 C.F.R. § 126.1(a), (e) (2011) (describing the prohibitions under the statute that were violated).

84. *See* ICE Agreement, *supra* note 76, at 3.

85. *See* Independent Research and Development Technical Descriptions, 77 Fed. Reg. 4632 (Jan. 30, 2012) (to be codified at 48 C.F.R. pt. 231).

86. *See* 48 C.F.R. §§ 231.205-18(c)(iii)(C) (2012).

87. *See* Memorandum from Timothy P. Callahan, Exec. Dir., Def. Contract Mgmt. Agency, to Component Heads, Regional Commanders/Directors, and CMO Commanders/Directors (Oct. 2, 2012), http://www.defenseinnovationmarketplace.mil/resources/Guidance_onAllowability(IRD)_under_DFARS-231-205-18(c)(iii)(C)signed.pdf [hereinafter Memorandum].

88. *See* Cheryl Pellerin, *New DOD Rule Supports Independent Research, Development*, AMERICAN FORCES PRESS SERVICE (Feb. 6, 2012), http://www.defense.gov/news/newsarticle.aspx?id=67068.; *cf.* Independent Research and Development Technical Descriptions, 77 Fed. Reg. at 4632 (discussing how proposed rule "should clarify" reporting requirements).

89. *See* Independent Research and Development Technical Descriptions, 77 Fed. Reg. at 4632.

90. *Id.* at 4634.

Not all contractors are required to report these expenses online. Only "major contractors," those "whose covered segments allocated a total more than US $11,000,000 in IR&D [and Bid and Proposal (B&P)] costs to covered contracts" in the previous fiscal year, are required to report costs online.[91] "Covered segments" are the "product division[s] of a contractor that allocated more than US $1,100,000 in [IR&D/B&P] costs to covered contracts in the preceding fiscal year."[92] All prime or subcontracts exceeding the simplified acquisition threshold are covered under this rule, yet fixed priced contracts are not covered.[93] All contractors who do not meet the threshold are encouraged to use online submissions as well, in order to improve the visibility of their work to the DoD.[94]

The information reported online will be accessible to the administrative contracting officer (ACO) and Defense Contract Agency Auditor (DCAA), along with other authorized personnel, for use in their roles determining the allowability of costs.[95] The specificity of detail given is left to the discretion of the contractor, but all are required to disclose project status, anticipated expenditures, technology area and subarea, benefitted DoD organizations, technology readiness level, a project summary and description, and contact information for the lead contact with up to five technical contacts.[96]

IX. The U.S.-U.K. Defense Trade Cooperation Treaty

On April 13, 2012, the United States and the United Kingdom exchanged diplomatic notes bringing into force the Treaty Between The Government of The United States of America and The Government of the United Kingdom of Great Britain and Northern Ireland Concerning Defense Trade Cooperation (the Treaty).[97] The Treaty is intended to simplify and facilitate the movement of defense equipment and technical data between the United States and the United Kingdom by creating an "Approved Community" of U.S. and U.K. government and private sector entities and facilities. "Approved Community" members are permitted to export certain defense articles, and defense-related technical data and services, within the "Approved Community" without obtaining export licenses as long as the exports or transfers are in support of one of the specified purposes of the Treaty.[98]

91. *See* 48 C.F.R. § 231.205-18(a)(iii) (2012).

92. *Id.* § 231.205-18(a)(ii).

93. *See* Memorandum, *supra* note 87.

94. *See* Independent Research and Development Technical Descriptions, 77 Fed. Reg. at 4635; *see also* Sandra I. Irwin, *Pentagon Wants More Accountability for R&D Funds Paid to Contractors*, NAT'L DEF. (July 9, 2012, 3:59 PM), http://www.nationaldefensemagazine.org/blog/Lists/Posts/Post.aspx?ID=830.

95. *See* 48 C.F.R. § 231.205-18(c)(iii)(C); *see also* Independent Research and Development Technical Descriptions, 77 Fed. Reg. at 4634.

96. *See Independent Research & Development (IR&D): Entering Project Data into the Defense Innovation Marketplace*, DEF. INNOVATION MARKETPLACE, 1-2, http://www.defenseinnovationmarketplace.mil/resources/2012618_Individual_Project_Data_Entry_Instructions.pdf (last updated June 18, 2012).

97. Treaty Concerning Defense Trade Cooperation, U.S.-U.K., June 21, 2007, S. TREATY DOC. NO. 110-7 (2007).

98. *Id.* at VI.

The Treaty was implemented in the United States through a new license exemption in the International Traffic in Arms Regulations (ITAR § 126.17),[99] and in the United Kingdom through a new Open General Export License (OGEL).[100] While many in the defense industry support the overall goal of easing export licensing burdens among close allies, some are concerned that the new ITAR exemption is overly complicated and the associated requirements are too burdensome to be truly workable for industry.

The U.S. Approved Community consists of U.S. government departments and agencies and non-governmental entities registered with DDTC. This group effectively includes any entity authorized to export pursuant to an ITAR exemption. The U.K. Approved Community consists of a more limited number of U.K. government entities and facilities and non-governmental facilities that have been vetted and approved by both the United States and the United Kingdom.

Many defense articles, technical data, and defense services qualify for license-free export pursuant to the Treaty. But various items are excluded. A full list of defense articles, technical data, and defense services that are exempted from the coverage of the Treaty is available on the DDTC website.[101]

The Treaty does not eliminate licensing requirements for commercial sales. Rather, it allows for license-free exports within the Approved Community only when in support of:

- Combined U.S.-U.K. military or counterterrorism operations;
- U.S.-U.K. cooperative security and defense research, development, production, and support programs;
- Mutually agreed to security and defense projects that are for U.K. government end-use only; and
- U.S. government end-use.[102]

The U.S. and U.K. governments must agree jointly on which projects, programs, and operations fall within these categories. The DDTC website provides the full list of specific U.S. government contracts or solicitations and HMG projects approved for export.[103] In addition, in order to facilitate use of the Treaty by federal contractors and subcontractors, the U.S. DoD is requiring program managers to identify qualifying defense articles and, if applicable, any specific Treaty-exempted technology before issuing solicitations or awarding contracts.[104]

Prior to exporting defense articles, technical data, or defense services pursuant to the Treaty, U.S. exporters must comply with all applicable marking and record-keeping requirements in order to ensure that export-controlled items continue to be recognized as

99. Announcement of Entry Into Force of the Defense Trade Cooperation Treaty Between the United States and the United Kingdom, 77 Fed. Reg. 33,089 (June 5, 2012) (announcing April 13, 2012 as the effective date of an earlier notice implementing the Treaty).

100. DEP'T FOR BUS. INNOV. & SKILLS (BIS), EXPORTS UNDER THE US-UK DEFENCE TRADE CO-OPERATION TREATY 2 (2012), *available at* http://www.bis.gov.uk/assets/biscore/eco/ogels-current/12-503-ogel-us-uk-defence-treaty.pdf.

101. *See Defense Trade Cooperation Treaties & Resources*, U.S. DEP'T OF STATE, http://www.pmddtc.state.gov/treaties/index.html (last updated Nov. 6, 2012).

102. Defense Trade Cooperation with the United Kingdom, 77 Fed. Reg. 30,361, 30,362 (May 22, 2012) (to be codified at 48 C.F.R. pts. 225, 252).

103. *Defense Trade Cooperation Treaties & Resources*, *supra* note 101.

104. Defense Trade Cooperation with the United Kingdom, 77 Fed. Reg. at 30,363.

such and handled accordingly. Retransfers or re-exports of items exported pursuant to the Treaty to a person or facility outside of the Approved Community will continue to require specific U.S. approval and U.K. authorization.

The ongoing implementation of the Treaty will be watched closely, not just by those involved in U.S.-U.K. defense trade. The United States and Australia have agreed to a similar treaty, which has been passed by the Australian Parliament and ratified by the U.S. Senate but has not yet been implemented.