

Covington Guide to Foreign Military Sales and Financing

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Covington's government contracts team offers a multidisciplinary approach to tackling the unique challenges presented by Foreign Military Sales and Direct Commercial Contracts transactions. Our lawyers have extensive experience working on these issues, drawing from Covington's nationally recognized practice groups specializing in government contracting, trade controls, and international corporate law as needed.

Introduction

U.S. government funding for sales of defense articles and services to foreign governments have soared in recent years.

In Fiscal Year 2020, the Defense Security Cooperation Agency reported \$50.8 billion in sales under the Foreign Military Sales (FMS) program and \$124.3 billion of Direct Commercial Contracts (DCC). The \$50.8 billion in FMS program transactions represents a 51 percent increase from just five years earlier.

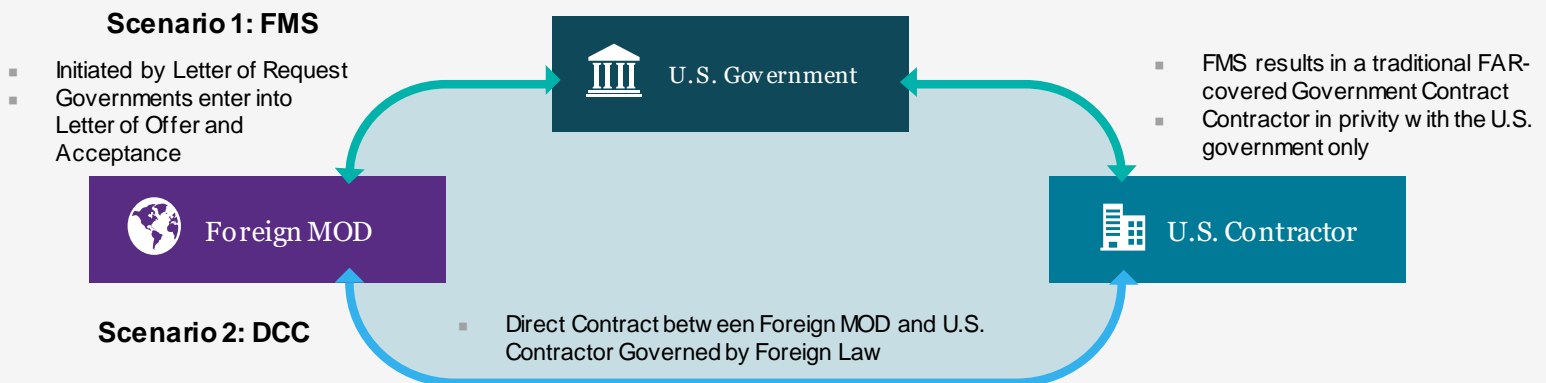
U.S. defense contractors operating in this arena must navigate a complex and multi-layered set of laws and regulations governing government procurements, export controls, and anticorruption. The applicability of these laws and regulations varies based on a variety of factors, including the nature of the transaction, the defense articles or services being exported, and the underlying source or sources of funding for the transaction. This guide offers an introductory primer on the myriad issues affecting FMS and DCC transactions.

Regulatory Regime Primer

FMS and DCC are alternative legal frameworks for U.S. government funding of the sale of defense goods or services to foreign governments. The core distinction between these frameworks is the role of the U.S. government. The U.S. government plays a regulatory oversight role in both FMS and DCC transactions, ensuring that the transactions comply with Arms Export Control Act of 1976 (AECA) and other applicable law. In FMS transactions, the U.S. government is a contractual party acting as an intermediary between the contractor and the foreign government. The contractor enters into a traditional U.S. procurement contract with the U.S. government, and the contractor is not in privity with the foreign government. Indeed, it is not always apparent from the face of a U.S. defense contract whether it involves an FMS sale.

In contrast, DCC transactions are directly between the contractor and the foreign government. These agreements are governed by applicable foreign law, although some foreign governments have specialized procedures for arms imports.

Comparison: Foreign Military Sales and Direct Commercial Contracts



Government Contracts Specialists



Fred Levy
Partner, Washington
+1 202 662 5154
filevy@cov.com



Nooree Lee
Special Counsel, Washington
+1 202 662 5909
nlee@cov.com



Rupert Harper
Partner, Dubai
+971 4 247 2120
rharper@cov.com

Offsets Specialist

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How the FMS Process Is Initiated

- 1 The FMS process is formally initiated by the foreign government submitting a letter of request (LOR) to the U.S. government, often through a representative at the local U.S. consulate. The LOR may request Price and Availability (P&A) data to obtain information for planning purposes, or be in the form of a Letter of Offer and Acceptance (LOA).
- 2 The LOA results in a contractual agreement between the foreign government and the U.S. government for the U.S. government's sale of specified defense articles and/or services.
- 3 The LOA is executed before a procurement contract is awarded by the U.S. government, and the pricing set forth in the LOA therefore is only an estimate; the foreign government is responsible for the cost of the ultimate procurement contract awarded by the U.S. government even if it exceeds the LOA pricing.
- 4 However, the pricing in an LOA provides a strong indication of the final pricing, as the LOA price often based on the foreign government's direct communications with industry. While the U.S. government ultimately negotiates the final contract price and enters into the contract, dialogue between industry and foreign purchaser is often key to a successful transaction.

Difference Between FMS and FMF

In conversations regarding authorized arms exports, the terms FMS and Foreign Military Financing (FMF) are frequently—and incorrectly—used interchangeably or together. FMS refers to sales in which the U.S. government acts as the contractual intermediary between the contractor and the foreign government. FMF refers to financing extended by the U.S. government to certain allied countries to procure defense articles or services through either FMS or DCC transactions. FMF takes the form of either grants or loans, and the loans may be repayable or non-repayable. The modern day FMF program consists almost exclusively of grants and nonrepayable loans. FMF is appropriated on an annual basis, with Egypt and Israel receiving the lion's share of funding.

FMF is authorized for DCC transactions with only Israel, Egypt, Jordan, Morocco, Tunisia, Turkey, Portugal, Pakistan, Yemen, and Greece, and such FMF funding is subject to various requirements set forth in guidelines administered by DSCA, including requirements related to U.S. manufacturing.

Considerations for Offset Agreements

Foreign governments may seek offset arrangements with defense contractors as part of FMS or DCC transactions. Foreign customers may seek direct offsets, which are offsets directly related to the defense articles or services being exported. Classic examples include host nation training and subcontracting requirements. Customers may also seek indirect offsets unrelated to the defense articles or services at issues such as a requirement for unrelated local purchases or technology transfer.

Offset agreements are side agreements to the primary arms export transaction and are typically governed by the law of the procuring country. Certain countries, such as the Republic of Korea and the United Arab Emirates, have established formal offset regimes, whereas other countries have less formalized procedures governing offsets. Establishing an offset agreement can be an involved affair that requires careful negotiation and due diligence, in particular as they can sometimes expose contractors to corruption allegations and risk around technology transfer.

The U.S. government is not a party to the offset agreements and does not become involved in offsets unless there is a direct regulatory impact—such as compliance with U.S. export control laws—or a direct contractual impact—such as the allow ability of offset costs as part of a U.S. contractor's contract costs.

Covington's Multidisciplinary, Global Approach to FMS and FMF

Our team of defense industry specialists covers the full set of capabilities and expertise to deliver on these transactions:



Government Contracts



Offset negotiation & delivery



Export Controls & Anticorruption



Disputes & Investigations



Guidelines for Foreign Military Financing

We are experienced across both traditional and new defense market segments (cyber, autonomous technology, etc.) and in operating in key markets such as the Middle East, the United Kingdom, Australia, and East Asia. Finally, our Public Policy team is also able to provide meaningful and unique insights into U.S. government and legislative processes and priorities, and the approvals necessary to bring these transactions to fruition.

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