

# THE GOVERNMENT CONTRACTOR®

Information and Analysis on Legal Aspects of Procurement



Vol. 64, No. 43

November 16, 2022

## Focus

### ¶ 332

#### No Man Is An Island In Defense Procurement: Developments In EU Defense Procurement Regulation And Its Implications For The U.S.

**Introduction**—The Russian invasion of Ukraine and the United Kingdom’s exit from the European Union have focused minds on the EU’s role as a defense actor. In the context of defense procurement, this includes whether the EU should itself co-fund cooperative programmes with Member States, what can be commonly procured, and how. The U.S. faces the obvious dilemma of needing to be seen to encourage EU initiatives which, if successful, would reduce reliance on the U.S. within the North Atlantic Treaty Organization (NATO) while also securing U.S. industry’s continued access to the European defense market(s). We explore the latest EU initiatives with a particular emphasis on implications for the U.S. For a useful introduction see Luke Butler, “Developments and Directions in EU Defense Procurement Regulation, and implications for the Defense Relationship between the EU and the UK,” *mostlyprocurement.typepad.com/myblog/2022/11/developments-and-directions-in-eu-defence-procurement-regulation-and-implications-for-the-defence-re.html*.

**Context**—Historically, the U.S. has played a formative role in developing defense cooperation within Europe. U.S. calls to rearm West Germany helped prompt proposals for the 1952 European Defense Community Treaty. This would have created

highly integrated European defense policies and institutions. Its non-ratification set the trajectory for what has become largely intergovernmental cooperation within EU Treaty structures. The European Defense Agency supports cooperative European defense projects, but the Member States within the EU decide on funding, and whom to cooperate with, and how, in accordance with national defense policies.

However, in 2009, the EU sought to harness its supranational internal market competences to address defense procurement. Historically, Member States invoked Article 346 of the Treaty on the Functioning of the European Union (TFEU), an essential security interest derogation, to exempt much defense procurement from compliance with internal market rules. This resulted in protectionist national defense markets. The response, EU Directive 2009/81/EC, was designed to open up the award of defense contracts to EU-wide competition through rules specially adapted to accommodate defense interests and thus reduce recourse to Article 346 TFEU. In the U.S., concerns were raised about the potential of the 2009 directive to lead to protectionism. E.g., Yukins, Feature Comment, “The European Defense Procurement Directive: An American Perspective,” 51 GC ¶ 383.

In hindsight, the U.S. need not have been too worried. First, no formal European preference was stated. The 2009 directive permits third country participation in procurement. While the EU Defense Directive provides no legal guarantees of non-discrimination and equal treatment, the U.S. has signed bilateral reciprocal defense procurement agreements with a number of European countries (but not the EU directly) which provide political guarantees of open defense markets across the Atlantic. Drew B. Miller, Note, “Is It Time to Reform Reciprocal Defense Procurement

Agreements?,” 39 Pub. Cont. L.J. 93 (2009). The reciprocal defense procurement agreements, as implemented in U.S. Defense Federal Acquisition Regulation Supplement pt. 225, also provide waivers of U.S. domestic preferences for these “qualifying countries” which enter into reciprocal agreements with the U.S. Department of Defense, a status easily revoked if guarantees are not respected. Second, the European Defense Directive contains important exclusions, not only for collaborative procurement between EU Member States to enable flexibility but also for procurement undertaken through NATO. Third, by whatever measure, the Directive has had limited impact on defense procurement in the EU. A 2021 evaluation report by the European Parliament acknowledged “uneven use and low degree of application,” and that the focus now is simply on improving implementation of the 2009 directive. European Parliament, *Report on the Implementation of Directive 2009/81/EC, Concerning Procurement in the Fields of Defence and Security, and of Directive 2009/43/EC, Concerning the Transfer of Defence-Related Products*, No. A9-0025/2021, [www.europarl.europa.eu/doceo/document/A-9-2021-0025\\_EN.html](http://www.europarl.europa.eu/doceo/document/A-9-2021-0025_EN.html).

Meanwhile, key aspects of U.S. weapons sales to Europe are not subject to EU regulation under the Directive. One prime area of exclusion is foreign military sales. Although outside the European Union, for a sense of scope, the U.S. has \$595.9 million in active government-to-government sales cases with Ukraine; key items include Javelin anti-armor missiles funded by a mix of U.S. foreign military financing and Ukrainian national funds. See U.S. State Department, *U.S. Security Cooperation with Ukraine*, [www.state.gov/u-s-security-cooperation-with-ukraine/](http://www.state.gov/u-s-security-cooperation-with-ukraine/).

Another area largely outside the EU Defense Directive is “offsets”—offsetting compensation (typically in the form of technology transfers or locally acquired goods or services) that purchasing governments often require of defense contractors. Offsets fall in a political and legal no-man’s land where foreign governments and contractors must negotiate a via media—a “middle way.” As the European Commission has observed, the Directive cannot “allow, tolerate or regulate” offsets, which leaves offsets to possible justification under Article 346 TFEU. Article 346 reserves to each EU

Member State the authority to “take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material,” and those measures may include offsets as part of a weapons purchase. See European Commission, *Directive 2009/81/EC on the award of contracts in the fields of defence and security – Guidance Note – Offsets (2016)* (“As restrictive measures infringing primary law, offset requirements can only be justified on the basis of one of the Treaty-based derogations, in particular Article 346 TFEU. However, these derogations must be limited to exceptional and clearly defined cases, and the measures taken must not go beyond the limits of such cases. They have to be interpreted strictly, and the burden of proof that the derogation is justified lies with the Member State which invokes it.”), [ec.europa.eu/docsroom/documents/15413/attachments/1/translations/](http://ec.europa.eu/docsroom/documents/15413/attachments/1/translations/). The U.S. also maintains a “hands off” policy regarding offsets, but recognizes their utility. See, e.g., Daniel Schoeni, “Defense Offsets and Public Policy: Beyond Economic Efficiency,” 76 *Air Force L. Rev.* 95 (2016).

The upshot is that the EU is not characterized by an increasingly autonomous European defense industrial base and an EU-wide defense market feeding a European preference—the vision of many at the time of the 2009 Defense Directive. Since 2017, the EU has begun to address a root problem of how to incentivize cooperative defense procurement between the Member States which could, in turn, drive industrial and market development. Of course, this was spurred in part by President Trump’s stance on NATO, the UK’s exit as a major defense player within the EU, and the need for accelerated and increased defense spending in light of Russian aggression. It has been observed that the direct involvement of third countries will be necessary to coordinate priorities, foster technology and material transfer, screen for investments by rivals, and monitor end-use of military capabilities. In this light, the issue arises as to how to synchronize third country participation in EU initiatives. See S. Blockmans, “Keeping Up with the Emerging European Defence Union: Synchronising Third Country Participation,” Norwegian Institute of International Affairs, Research Paper – 2/2022, [www.nupi.no/en/publications/cristin-pub/](http://www.nupi.no/en/publications/cristin-pub/)

*keeping-up-with-the-emerging-european-defence-union-synchronising-third-country-participation.*

**European Defense Fund**—An important development to observe is that the EU is now beginning to fund collaborative projects in defense through the European Defense Fund (EDF). Whatever the sums (and they are not substantial), these research and development grants involving the use of EU funds rather than exclusively Member State financing means that there is now “top down” support for projects driven “bottom up” through Member State proposals. In 2017, the EDF was established. See European Union, European Defence Fund, *defence-industry-space.ec.europa.eu/eu-defence-industry/european-defence-fund-edf\_en*. As indicated, the sums are not substantial by U.S. standards of defense spending. For 2021–2027, €8 billion (€2.7 billion for research; €5.3 billion for development) has been allocated through the EDF. Its relatively small scale is further evidenced by the fact that the EDF is intended to incentivize cross-border small and medium-sized enterprise (SME) participation by providing higher funding rates and favoring projects by consortia which include SMEs and which focus on innovation: four to eight percent of the budget will be set aside to support innovative disruptive technologies for defense that will boost Europe’s long-term technological leadership and contribute to high-end defense products. Research activities can be funded up to 100 percent while development activities have different funding rates between 20–80 percent from prototyping to certification. Generally, only collaborative projects are eligible, and those must include at least three Member State participants/associated countries. However, an important limitation is that the Fund does not cover acquisition itself. As with many of the new EU initiatives, the actual mechanisms for procuring the results (awarding contracts, subcontracts, and workshare etc.) are left to coordination between Member States. To confirm, no capability will be owned by the EU. If eligible, activities developed through Permanent Structured Cooperation (PESCO) (discussed below) may receive a higher EU funding rate.

On launch, the EDF was identified as a major potential barrier to transatlantic defense procurement, including possibly violating the reciprocal defense procurement agreements between the U.S.

Department of Defense and its counterpart ministries of defense in the European Union. See, e.g., Yukins, Feature Comment: “European Commission Proposes Expanding The European Defence Fund—A Major Potential Barrier To Transatlantic Defense Procurement,” 60 GC ¶ 196. As a result, the EDF triggered sharp objections from the U.S. See, e.g., Daniel Fiott, “The Poison Pill: EU Defence on U.S. Terms?” (EU Institute for Security Studies 2019) (recounting U.S.-EU exchange). In 2021, an EDF Regulation was adopted laying down its budget and the forms of, and rules for, EU funding. Regulation (EU) 2021/697 of the European Parliament and of the Council of 29 April 2021 Establishing the European Defence Fund and Repealing Regulation (EU) 2018/1092, OJ L 170 (12 May 2021), pp. 149–177. As these provide a clearer indication on the treatment of third country participation, it is useful to revisit the EDF Regulation’s formal implications for the U.S.

First, the EDF Regulation does limit the eligible legal entities who can participate. Recipients and subcontractors involved must not be subject to “control” (Art. 2(6)) by a “non-associated third country” or entity (Art. 2(24); (Art. 9(3)). The rationale appears to be two-fold. The first is one of principle in that the Fund aims to enhance the competitiveness and efficiency of the EU’s defense industry (Art. 15.) The second concerns protection of Member State and, apparently, EU security interests. It is stated that the infrastructure, facilities, assets and resources of recipients and subcontractors involved should be located on Member State territory for the duration and have their executive management structures so located. *Id.*

It is equally important to acknowledge, though, the pragmatic reality that third country controlled legal entities can still participate. By way of “derogation,” a third country controlled legal entity *shall* be eligible to be a recipient or subcontractor, although subject to guarantees established in accordance with national procedures which may refer to the legal entity’s executive management structure and specific governmental rights in that control (Art. 9(4) and Recital 16.) Essentially, the guarantees have to ensure that any control does not restrict access to resources, intellectual property, etc., that third country access to sensitive information is prevented (which includes rules on handling classified information) (Art. 27), that

national security clearances must be in place as appropriate, and that ownership of the intellectual property and the results must remain with the recipient during and after completion and not be subject to third country control or restriction, nor exported without the Member State's approval (Art. 9(4) and Recital 16). There are also other apparent accommodations; for example, where no "competitive substitutes" are readily available in the EU, recipients and subcontractors may use their assets and resources located outside the EU; the costs related to those activities shall not be eligible for support from the Fund (Art. 9(5)). In addition, recipients and subcontractors may cooperate with legal entities established outside Member States' territories subject to limitations to the effect that there shall be no unauthorized access to classified information or potential negative effects on security of supply; the costs related to those activities shall not be eligible for support from the Fund (Art. 9(6)). It follows that the products of research and development must not be subject to third country control or restriction, including in terms of technology transfer (Articles 20, 23).

At this stage, it is perhaps too early to determine the potential impact, if any, that the legal niceties of various tests under the EDF Regulation (for example, the question of "control" (the ability to exercise a "decisive influence" etc.), or the requirements for guarantees regarding technology controls) will actually have on U.S. firms' participation under the EDF. While, in theory, these look like broad restrictions with some potential sticking points (intellectual property retention and use always being one), it is difficult to see how these conditions can be substantially enforced within a skeletal framework. There is also the fact that the U.S. is participating in EDF-funded projects through the EU's Permanent Structured Cooperation (PESCO) initiative—€1.7 billion of EDF funding is available for the PESCO Military Mobility project involving the U.S., Canada and Norway. See Council of the European Union, Press Release, "PESCO: Canada, Norway and the U.S. will be invited to participate in the project Military Mobility" (6 May 2021).

**Permanent Structured Cooperation (PESCO)**—Under PESCO, EU Member States have "launched several initiatives to step up security and defence cooperation within the EU

framework." European Union External Action Service, "Permanent Structured Cooperation (PESCO) – Factsheet" (March 25, 2022). These PESCO initiatives can be funded through the EDF. Articles 42, 46 and Protocol No.10 of the Treaty on the European Union already provide a legal basis for Member States which have made mutual commitments to one another to develop defense capabilities through national and European programmes. PESCO is also acknowledged to be a response to repeated demands for stronger transatlantic burden-sharing. Council Decision (CFSP) 2017/22315 ([eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017D2315](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017D2315)) formally established PESCO commitments and governance, and 25 Member States have joined. What is said to distinguish PESCO is the legally binding nature of the commitments undertaken, albeit again in a skeletal form. Without going into too much detail, it sets the terms for participation which is voluntary and provides a means by which participating states can initiate project proposals and set arrangements for cooperation and project management. The European Council provides strategic direction on various matters, such as establishing governance rules for projects and the general conditions for exceptional third state participation (on which see below). In terms of financing, the operating expenditures for projects are supported primarily by participating Member States. Contributions from the general EU budget may be made to such projects. However, PESCO assets remain Member State-owned. More broadly, the Council Decision also sets out 20 so-called "more binding commitments," e.g., to increase national defense spending. There are currently 60 PESCO projects being developed ([www.pesco.europa.eu/](http://www.pesco.europa.eu/)) and the EU has also acknowledged Ukraine's wish to join PESCO projects.

The formal position is that third countries can be invited to participate in PESCO but only exceptionally. This reportedly led the U.S. to indicate potential retaliation in the form of reciprocal restrictions on EU companies operating in the U.S. defense market. See Guy Chazan & Michael Peel, "U.S. Warns Against European Joint Military Project: Washington Letter to Brussels Threatens Retaliation if American Groups Are Shut Out," *Fin. Times*, May 14, 2019. However, for all the political symbolism of rendering third party participation

exceptional, it is worth acknowledging that some EU Member States (e.g., Poland, which has since become a strategically significant player in the Ukraine war) were particularly vocal on the centrality of third country participation as the only missing piece within PESCO's institutional framework. Andrzej Sadoś, "How to Further Develop European Security and Defence Cooperation" (Nov. 6, 2022), [www.euractiv.com/section/defence-and-security/opinion/how-to-further-develop-european-security-and-defence-cooperation/](http://www.euractiv.com/section/defence-and-security/opinion/how-to-further-develop-european-security-and-defence-cooperation/). Indeed, it is understood but unconfirmed that the position on third country participation was resolved even before the rules on PESCO, although the U.S. intended to keep pressing for changes. See Steven Erlanger, "Europe Vows to Spend More on Defense, but U.S. Still Isn't Happy," *N.Y. Times*, June 6, 2019. In 2020, Council Decision (CFSP) 2020/1639 (*eur-lex.europa.eu/eli/dec/2020/1639/oj*) was published establishing the general conditions for third country participation.

As indicated, in May 2021, the U.S., Canada and Norway were invited to join the PESCO Military Mobility project ([www.pesco.europa.eu/project/military-mobility/](http://www.pesco.europa.eu/project/military-mobility/)) to facilitate cross-border troop and equipment movement and to harmonize transportation rules. The UK has also since joined. Further, the benefits of certain PESCO projects for NATO have also been identified as initiatives that benefit the U.S. strategic position in Europe, such as the TIGER Mark III attack helicopter upgrade to be performed by Airbus. See Chris Riehl, "PESCO is in the American Interest," *International Affairs Rev.*, 1 Apr. 2022, [www.iar-gwu.org/blog/a535fp9un5oo9hqv8d7olhyxwq23b5](http://www.iar-gwu.org/blog/a535fp9un5oo9hqv8d7olhyxwq23b5); "France and Spain launch Tiger MkIII programme" (March 2, 2022), [www.airbus.com/en/newsroom/press-releases/2022-03-france-and-spain-launch-tiger-mkiii-programme](http://www.airbus.com/en/newsroom/press-releases/2022-03-france-and-spain-launch-tiger-mkiii-programme).

**Common Procurement**—In March 2022, the EU published its Strategic Compass Plan setting out the EU's ambition for defense and security. See [www.eeas.europa.eu/eeas/strategic-compass-eu-0\\_en](http://www.eeas.europa.eu/eeas/strategic-compass-eu-0_en). One aspect relating to procurement is the EU's efforts to increase common procurement, i.e., not just the funding of development but also the buying of equipment. To this effect, a Communication has been published on joint acquisition of military equipment, strategic defense programming and supporting the European industrial base. See European Commis-

sion, EU Steps Up Action to Strengthen EU Defence Capabilities, Industrial and Technological Base: Towards an EU Framework for Joint Defence Procurement (May 18, 2022), [ec.europa.eu/commission/presscorner/detail/en/IP\\_22\\_3143](http://ec.europa.eu/commission/presscorner/detail/en/IP_22_3143). An EU Defense Joint Procurement Task Force has been established to work with Member States to support coordination of their procurement needs and military assistance to Ukraine.

This is reinforced by a draft proposal for a Regulation establishing a European Defence Industry Reinforcement Through Common Procurement Act (EDIRPA) for 2022–24, [ec.europa.eu/commission/presscorner/detail/en/IP\\_22\\_4491](http://ec.europa.eu/commission/presscorner/detail/en/IP_22_4491). The EDIRPA aims at supporting cooperation in "common procurement" defined as a cooperative procurement jointly conducted by at least three Member States. See Proposal for a Regulation on Establishing the European Defence Industry Reinforcement Through Common Procurement Act, COM/2022/349 (July 19, 2022). The EDIRPA has a budget of €500M. The Regulation would prescribe eligible actions, such as those involving cooperation for common procurement of the most urgent and critical defense products (excepting lethal autonomous weapons), the possibility to appoint a procurement agent on behalf of members, award criteria which are stated in broad terms, and implementation through a work programme. In respect of third countries, the proposed Regulation repeats the language found in the EDF Regulation, namely, that common procurement contracts will need to be placed with legal entities established in the EU/associated countries and are not subject to control by third countries/entities (Art. 8). However, the proposed Regulation also contains the same derogation permitting third country controlled contractor and subcontractor participation in common procurement, provided guarantees are met. By way of important update, on Nov. 11, 2022, it was reported in the *UK Financial Times* that a new draft of the EDIRPA was in circulation. Henry Foy, "EU Waters Down Its Buy-Local Defence Push," Nov. 11, 2022, [www.ft.com/content/7a7a194e-db09-45c7-9faa-7afc52aa9e29?sharetype=blocked](http://www.ft.com/content/7a7a194e-db09-45c7-9faa-7afc52aa9e29?sharetype=blocked). It has been reported that Member States are now proposing a "workaround" to allow the EU fund to support joint purchases from third countries, not least to meet short-term needs and restock arsenals depleted by the necessity to supply weapons to Ukraine.

As a further indication of increased EU incentivization for cooperative procurement, according to the EU’s Strategic Compass, by early 2023 it will publish a Commission proposal to enable a VAT waiver to support the joint procurement and ownership of defense capabilities which are the result of collaboration within the EU. See European Commission, *Questions and Answers: Commission Contribution to European Defence in the Context of the Strategic Compass* (Feb. 15, 2022), [ec.europa.eu/commission/presscorner/detail/en/QANDA\\_22\\_925](https://ec.europa.eu/commission/presscorner/detail/en/QANDA_22_925). This appears to be the first publicized tax relief measure to incentivize EU collaborative procurement. Relatedly, the EDF may be adjusted, and these changes may include reinforcement of the EDF’s bonus system applicable when Member States commit to jointly acquire and/or own the defense capabilities under development.

**Conclusion**—The EU’s ambition to develop initiatives on cooperative defense procurement are laudable. The Russian invasion of Ukraine has bolstered the case for strengthened defense cooperation within Europe, and that cooperation almost certainly will be strongly supported by the U.S., particularly if it strengthens NATO.

An important question is the perennial one—to what extent, if at all, will this impact U.S. interests. This Feature Comment has first advised caution; we will need to wait and see. As indicated, putting recent developments in historical context, the EU has not been able to harness various initiatives in defense procurement to develop anything close to a strong sense of a uniform “European Defence Technological Industrial Base” and “European Defence Equipment Market,” as so often mentioned in policy documents. The European Defense and Security Procurement Directive has not even been fully implemented, and it has not facilitated a European preference to the exclusion of U.S. defense firms. Moreover, while the EDF and PESCO are important initiatives which signal the first solid commitment to EU funding in defense, the sums are relatively small, and they rely on a model of voluntary participation of the limited number of Member States who “can do” in defense, i.e., have “credible” capability (which now means the ability to dissuade a nuclear power from launching full-scale conventional forces on European territory, not the ability to undertake basic peace keeping). These do not come close to representing a “leveling

up” of defense standards across the EU. Given the annual U.S. defense spend (over \$300 billion in contract awards), a few billion euros for not just one annual project but hundreds of projects over almost a decade might lead the U.S. to question the value of participation, except to continue to show strategic influence in European defense.

While the EU has been tough on rhetoric in seeking to render third country participation in EU defense cooperation exceptional, the reality is quite different. The legal instruments speak for themselves. Both the EDF Regulation (on EU funding for joint defense research and development) and the PESCO initiatives (Member State cooperative efforts) allow third country participation subject to guarantees. Moreover, if the latest reports on the proposed Regulation for the EDIRPA are to be believed, a further relaxation on third country participation is intended. Of course, the U.S. is also now participating in PESCO projects partially funded by the EDF. Even the United Kingdom is participating in PESCO projects.

These fascinating developments are an important reminder that the EU must carefully consider the third country implications of its EU defense procurement initiatives. Of course, this is not simply the case in respect of the U.S. (with the U.S. negotiating influence on the EU instruments plain to see or at least infer) but also the United Kingdom, as “third country” participation will not simply be synonymous with “the U.S.” Indeed, an even thornier issue concerns the participation of Turkey. The issue of how to address third country participation also is not confined to defense, as indicated by 2019 EU Guidance on third country participation in the EU procurement market generally. [single-market-economy.ec.europa.eu/news/new-guidance-participation-third-country-bidders-eu-procurement-market-2019-07-24\\_en](https://single-market-economy.ec.europa.eu/news/new-guidance-participation-third-country-bidders-eu-procurement-market-2019-07-24_en).

A final reflection is on John Donne’s observation that “no man is an island.” Cooperation is not a case of “U.S. and us” and “them.” The F-35 aircraft, for example, is not a uniquely U.S. project but a collaborative effort involving many countries. Similarly, the Next generation Light Anti-Tank Weapon is not uniquely British but European. True cooperation requires coordination between international organizations (NATO/EU), countries and multiple funding sources. If the transatlantic alliance between the U.S. and the EU will continue to evolve to meet the realities of events

of the kind which have unfolded in Ukraine, careful consideration must be given as to how that cooperation will operate not only politically but also legally. On which point, this is a renewed call for lawyers to get involved in the debate on ways to improve transatlantic defense cooperation. See Luke R.A. Butler, “Transatlantic Defence Procurement: EU and U.S. Defence Procurement Regulation in the Transatlantic Defence Market” (Cambridge University Press 2017).



*This Feature Comment was written for THE GOVERNMENT CONTRACTOR by Luke R. A. Butler, Michael Bowsher KC & Christopher Yukins. Prof. Butler is an Associate Professor (Reader)*

*in Law, Director of the Executive Programme in Public Procurement Law and Policy, and a member of the Public Procurement Research Group at the University of Nottingham. Mr. Bowsher is a barrister at Monckton Chambers and a Visiting Professor at King’s College, London. And Prof. Yukins is the Lynn David Research Professor in Government Procurement Law at the George Washington University Law School. All three authors recently participated in a webinar series on transatlantic defense procurement, available at [publicprocurementinternational.com/defense-procurement-webinars/](http://publicprocurementinternational.com/defense-procurement-webinars/).*