

BRINGING DEFENSE BUSINESS HOME



JAROSŁAW WITEK, PARTNER, RESPONSIBLE FOR LEADING THE MULTIDISCIPLINARY DEFENSE AND SECURITY GROUP IN POLAND AT DENTONS, EXPLAINS THE REQUIREMENTS FOR COMPANIES INTENDING TO ENTER INTO DEFENSE OFFSET DEALS WITH THE POLISH GOVERNMENT.

Apart from granting 50 percent of the funds on technical modernization to the Polish defense industry, the new Polish government is committed to using offsets and involving more Polish companies in defense contracts made with foreign suppliers through the so-called policy of "Polonization". The willingness to make greater use of offsets and involve more domestic defense technology companies comes as a result of the Russian aggression on Ukraine. With the reevaluation of Poland's defense priorities comes an acceleration in the development of the domestic defense industry. Poland looks at a cooperation potential with Germany and France within the Weimar Triangle, including sharing the production of defense equipment. Offset deals in this area, along with "Polonization" are perceived as useful tools to strengthen the Polish defense industry and the potential of the Polish Armed Forces. With this, there are huge opportunities for foreign defense companies and technology suppliers, given they are competent in entering into offset deals.

OFFSET SCOPE

Under the Offset Act, offset commitments mainly refer to the transfer of technology to secure the required degree of independence of Poland from the foreign supplier in terms of

production and MRO capabilities. The Polish government expects solely intangible offset commitments consisting of the transfer of or licensing technology and know-how. No tangible offset commitments, including the direct purchase of goods and services, sales assistance through a marketing network, or share purchase and share capital contributions are allowed.

The value of an offset agreement is specified on a case-by-case basis. The Offset Act—designed to achieve technology transfers—does not provide for offset multipliers, and therefore, a nominal value of all offset commitments should be taken into consideration while establishing the overall offset value. In practice, the value is proposed by the foreign supplier within the scope of its sovereignty and based on a chosen evaluation methodology and agreed to with the Polish government. In case of non-performance or improper performance of the offset commitments, a foreign supplier is obliged to pay contractual penalties—which under Polish law constitute a form of liquidated damages. Under the Offset Act, the value of the contractual penalty for non-performance of an offset commitment should equal the value of the non-performed offset commitment. Similarly, in the event of improper perform-

ance of the offset commitment, the value of the contractual penalty should equal the value of the improperly performed part of the offset commitment (the so-called partial performance). Consequently, in the case of non-performance or improper performance of offset commitments, the foreign supplier is obliged to pay a contractual penalty equal to 100 percent of the value of the non-performed or improperly performed part of the offset commitment. In practice, during negotiations, it is possible to adopt certain departures or variations from the above rules. Under Polish law, contractual penalties are due irrespective of whether the Polish government incurred any loss from the non-performance or improper performance of the offset agreement. Additionally, the foreign supplier may be obliged to pay an additional (supplementing) compensation if, as a result of non-performance or improper performance of the offset commitments, the Polish Government suffers damage exceeding the stipulated contractual penalties. However, in such a case, it is the Polish government that is obliged to prove the loss, the non-performance or improper performance of the offset agreement, and the

causal nexus between those elements. The foreign supplier may, in place of liquidated damages, submit a proposal to perform a replacement offset project. The offset agreement usually provides for the upper limit of a foreign supplier's liability (cap of liability) under a given offset agreement. While performing an offset agreement, the foreign supplier is liable for its subcontractors to the same degree as for its actions and omissions. The Polish government is entitled to demand, no later than on the date of conclusion of an offset agreement, a performance bond in the amount not lower than the value of the offset agreement (100 percent) in the form of either a statement on voluntary submission to enforcement proceedings; a bank guarantee; or a blank promissory note—each to be called/collected "on the first demand" upon pre-drawing notice/cure period). Consequently, the performance bond is required before the execution of an offset agreement and always in the total amount of 100 percent of the value of the offset agreement which may significantly increase the costs of offset and should be taken into consideration before making

a binding proposal. In practice, two separate performance bonds may be submitted a cost-free one for the entire 100 percent; and an additional collateral at certain milestones and for a limited amount. If so, the Polish government would be entitled to benefit only from one performance bond to seek a given claim. In any case, both performance bonds are governed by Polish law. The Polish government is entitled to benefit from performance bonds only if a foreign supplier refuses to pay liquidated damages directly to the Polish government upon demand. Under the Offset Act, the supply contract may be signed only following the approval of an offset agreement. Consequently, an offset agreement should be considered a condition precedent of signing the supply contract. The latter may not be concluded before obtaining formal approval and signing of the offset agreement which may significantly extend the execution of the supply agreement for the period required to obtain the approval and signing of an offset agreement.

The offset agreement is concluded for a maximum 10-year period and expires at the date when the Polish Government acknowledges the performance of all offset commitments by the foreign supplier or upon payment of contractual penalties resulting from the non-performance or improper performance of the offset commitments. The application for crediting the performance of the offset commitment would be submitted within 90 days from the final performance date of a given offset commitment.

Under the Offset Act, neither

party may terminate or withdraw from an offset agreement.

In addition, under the Offset Act, offset agreements should be governed by Polish law. Although the jurisdiction is not defined by law, the Polish government always insists that Polish common courts have exclusive jurisdiction over offset agreements. Offset agreements are concluded solely in their Polish language versions.

OFFSET IN FMS

Generally, in terms of the offset obligations to be imposed on foreign suppliers, the Offset Act does not distinguish between Foreign Military Sales (FMS) in which the military equipment is acquired through the US government, and the acquisition of the military equipment is commenced directly from its manufacturers.

Despite certain concerns as to the literal wording of the Offset Act, the Letter of Offer and Acceptance should be considered an equivalent of a supply agreement which generates an offset obligation that can be imposed by the Polish government. As the US government cannot be involved in an offset, offset obligations should be imposed directly on US defense contractors delivering their respective components to the US government.

POLONIZATION

On top of the offset mechanism, the concept of Polonization should be addressed.

Polonization, which as the name suggests, is aimed at making the product "more Polish", constitutes another way of allowing the Polish defense industry to be involved in the delivery of imported weapon systems and to make the Polish defense

industry benefit from the modernization of the Polish Armed Forces by developing domestic production and sustainment capabilities in the long term.

Polonization should be understood as the participation of Polish companies in the production and delivery of the goods being provided to the Polish Government by a particular foreign supplier. There are two key models of such participation. The main one consists of adapting the acquired systems to Polish requirements with the use of Polish components and subsystems. Consequently, Polonization entails a constant and continuous involvement of Polish entities in the production of goods being delivered to the Polish Armed Forces. As long as the foreign supplier locates a part of its production in Poland—it either purchases the components or raw materials from the Polish partners, subcontracts assembly or other services to Polish subcontractors, or uses Polish manpower for production processes, the Polonization requirement can be met. The second model involves designing by the Polish defense industry an original platform to be integrated with various key components, acquired either off-the-shelf or through licenses from abroad where the key Polish defense industry effort is focused on integrating crucial components within a novel platform, developed specifically to meet the distinct requirements of the Polish Armed Forces.

Polonization as such existed in the Polish legal system in the past as an integral part of the offset obligations. The fulfillment of the Polonization commitments was credited against the value of the offset agreement on the same terms as other offset

commitments. Recently, the Polish Government has been returning to the concept of pure Polonization within two scenarios described above, in particular in light of the offset limitations. As Polonization constitutes a separate foreign supplier's obligation and constitutes an important criterion in evaluating bids, the Polish Government is entitled to provide the Polonization requirement, at least theoretically, irrespective of whether it is necessary for the protection of the national security interests or not. Consequently, the Polish government is not obliged to specify and justify, on a case-by-case basis, the security interest that makes a particular Polonization requirement necessary and to demonstrate that it cannot achieve the same objective by less restrictive means.

The concept of Polonization has been recently widely invoked by the Polish government, among others, in its transactions with South Korea.

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