

Briefing Document

Defence Briefing

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Introduction

In this Briefing we consider developments in the bribery and corruption field, the competition regime affecting complex weapons, Article 346 of the EU Treaty, new European Union export control authorisations and new points of interest in relation to final salary pension schemes.

Bribery and Corruption – dividend payments recovered from parent company

In 2008 Mabey & Johnson (M&J) self-reported certain irregularities that it had discovered as a result of an internal investigation. Subsequently, M&J pleaded guilty to charges of corruption and breaches of United Nations sanctions in relation to certain bridge building contracts in pre-liberation Iraq. This resulted in it paying fines and reparations totalling £6.5m. Two directors subsequently received prison sentences. Now, the SFO has ordered the holding company of M&J to pay over £130,000 under the Proceeds of Crime Act 2002. Although the sum itself is not particularly significant, the principle is. The sum represents the dividends which the parent company collected from the subsidiary in respect of the contracts the subject of the earlier prosecutions. This is the first time that the SFO has recovered proceeds of crime by targeting dividends which have been paid by a subsidiary.

The lessons to be learnt from this long running investigation are threefold:

- The authorities will look favourably on self-reporting and a willingness to change the culture of an organisation that has been tainted by the past behaviour of rogue individuals. The SFO has publically recognised the assistance which the management of M&J has given to it to allow the due process of law to take its course.
- The proceeds of crime may be traced to other companies within a group.

- The emphasis that the SFO put on shareholders and investors in companies to satisfy themselves of the business practices of the companies in which they invest. In this case the shareholder was unaware of the behaviour in question. In future we expect to see even more rigorous due diligence in respect of this area of an acquisition or investment. We also expect some transactions to fail because of concerns which may be unearthed by the due diligence exercise. Protection taken by an investee or acquirer in the form of indemnities would have to be limited in scope to meet the requirements of public policy and could not mitigate against any reputational damage.

There has been significant press coverage of the SFO's position. Some of that coverage has been critical of the SFO's stand, arguing that it places an unreasonable burden on institutional shareholders and investors.

In a speech on 18 January 2012 Richard Alderman, the Director of the SFO, defended the SFO's actions and made it clear that further actions like this were likely. The following is an extract from his speech:

".....There are other cases we are looking at where we shall do this again. [T]here was criticism about what was seen as a further burden on shareholders, particularly institutional shareholders. I have to say I do not understand that. Institutional shareholders are not just passive recipients of dividends; they also have regular discussions with the management of the businesses in which they hold shares.

I am going to have discussions soon with representatives of institutional shareholders. I am going to ask them whether any of them have asked management if they are satisfied that their companies have adequate procedures under the Bribery Act. If they have not asked that question, I shall want to know why not. After all, we all know that a corruption investigation can have a devastating effect on the share price of a company. If institutional shareholders are not concerned about that, then it seems to me that they are not living up to their ownership responsibilities and are not doing what society expects from them."

If you wish to read the whole speech, click [here](#).

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Complex Weapons – open to competition

Background

Since August 2007, agreements relating to complex weapons and supporting technology have been exempted from the competition regime for reasons of public policy. Click [here](#) to see our May 2008 Briefing which gives more information on the small number of exclusion orders which have been granted by the UK competition authorities. In December 2011 the Competition Act 1998 (Public Policy Exclusion) (Revocation) Order 2011 was published, revoking the complex weapons exemption with effect from 30 December 2011.

This means that from 2012 agreements relating to complex weapons will have to comply with UK competition restrictions.

The UK competition regime

The Competition Act 1998 prohibits:

- agreements and concerted practices between undertakings which may affect trade and has as their object or effect the prevention, restriction or distortion of competition within the UK (the Chapter I prohibition)
- abuse of a dominant position (the Chapter II prohibition).

The 2007 exclusion

The 2007 order provides that the prohibitions do not apply to agreements or conduct between certain companies (these are MBDA UK, Thales Air Defence Limited, Thales Missile Electronics, Roxel UK and QinetiQ, which together comprise "Team CW") (a) which relate to a complex weapon or supporting technology, (b) where the purpose is to protect essential security interests of the UK, and (c) where there is no wider effect on competition other than in the market for complex weapons or supporting technology.

What does the revocation mean in practice?

When the exclusion order was initially granted the competition authorities recognised that Team CW needed to share commercially confidential information, undertake industrial rationalisation by allocating geographical areas to specific suppliers and apply dissimilar conditions to equivalent transactions. All of these practices are contrary to the Competition Act.

The dismantling of the Team CW alliance means that, individually, its members will lose market power and the ability to allocate MoD contracts between themselves. Theoretically, the increase in competition should lead to

the MoD purchasing products at a lower price. However, the MoD has decided to enter into bilateral agreements with its suppliers in the absence of the alliance. It may be that the bilateral agreements relate to specific areas of the UK which were previously allocated, meaning that there will be little change in competition for the supply of these products. But the previous members of Team CW will no longer be able to rely on their collective market power, market allocation and information exchange when supplying the MoD. Competition should reduce prices, leading to cost savings for the MoD.

Developments in Dual-Use

A new Council Regulation (Regulation 1232/2011), in force from 7 January 2012, amends and supplements the existing Dual-Use Export Regulation (428/2009) and creates five new EU General Export Authorisation (EU GEA's) (the EU equivalent of UK Open Export Licences) permitting the export of certain dual-use items. The Regulation is intended to further harmonise the EU dual-use export regime and to promote competition between Member States. Accordingly, the new Regulation will be welcomed by exporters in facilitating the export of low-risk items from the EU to specific "friendly" destinations.

Subject to conditions, there are now EU GEAs for: (a) export of most controlled items to the USA, Canada, Australia, New Zealand, Japan, Norway and Switzerland including Liechtenstein (this is a slight amendment to the existing Dual-Use Regulation); (b) export of certain items to Argentina, Croatia, Iceland, South Africa, South Korea and Turkey; (c) export of certain items to specified destinations following repair or replacement; (d) export of certain items to specified destinations temporarily for the purposes of exhibition or fair; (e) export of certain telecommunications items to specified destinations; and (f) export of certain listed chemicals to specified destinations. The new Regulation permits Member States to prohibit an exporter from using the EU GEAs if there is 'reasonable suspicion about his ability to comply with such authorisation or with a provision of the export control legislation' and provides for improved information exchange between Member States. The negotiation of agreements with countries outside the EU for the mutual recognition of dual-use item export controls and to remove authorisation requirements for re-exports is also envisaged.

The Commission is obliged to review the new Regulation by no later than 31 December 2013 to assess, in particular, whether a EU GEA on low value shipments should be introduced.

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The Export Control Office's (ECO) advice to exporters who may be impacted by the new Regulation is to read and understand the new legislation and guidance and to register with ECO via the SPIRE website. Registration is required before an exporter can take advantage of the new open licences.

The ECO also published a new version of the UK Strategic Export Control lists this month. Exporters should check the new list for any amendments that are relevant to their export activities.

Article 346 EC Treaty

Article 346 permits contracts relating to "the essential interests of....[a nation's] security which are connected with the production of or trade in arms, munitions and war material" to be exempted from the usual public procurement rules. The European Commission believes that many EU member states have relied on a very wide interpretation of Article 346 to avoid the regulatory regime in the defence sector, arguably to protect national suppliers.

In part that has been addressed by the Defence and Security Directive 2009/81/EC which legislated for member states to harmonise procurement procedures for defence and national security related contracts. The Directive is intended to provide a regulatory framework which is better suited to defence procurement than the existing arrangements so as to discourage member states from opting out of compliance by invoking the Article 346 exemption. The Directive has been brought into force in the UK in the form of the Defence and Security Public Contracts Regulations 2011. Click [here](#) to read our Briefing on the Regulations.

In a recent ruling which is consistent with overall EU policy the ECJ has ruled that, in respect of a Finnish procurement, an item which is to be used for specific military purposes, but which viewed objectively is no different from similar items used in a civilian context, cannot be excluded from the procurement rules by relying on Article 346.

Final Salary Pension Schemes

Many defence contractors operate final salary pension schemes. The following points may be of interest:

CPI switch is lawful for public sector schemes:

In December 2011 the High Court ruled that HM Government's decision to switch the basis on which public sector pensions are indexed to CPI from RPI is lawful. However, this decision may not be the end of the matter as

the trades unions who brought the claim are appealing against the decision. Although the decision primarily affects public sector schemes a successful appeal may impact on private sector schemes. We will report on the outcome of the appeal when it is known.

Whether the switch to CPI affects private sector schemes will depend on whether your rules on increases on pensions in payment and revaluation of deferred members' benefits refer directly to legislation. If they do, then changes made by the Revaluation Order 2010 and the Pensions Act 2011 to switch the basis of these indexes to CPI will automatically apply to the scheme's calculations. Conversely, if your rules refer to RPI without going back to the underlying legislation your scheme may still need to calculate revaluation and indexation by reference to RPI. Scheme managers may also find that they may need to calculate part of members' benefits by reference to RPI and part by reference to CPI, due to the particular wording of their rules.

Fair Deal or no Fair Deal:

In March 2011 H M Government began consulting on the future of the Fair Deal pensions policy and in particular whether its continued application to outsourcing exercises and staff transfers from the public sector acts as a barrier to private sector involvement in the provision of public services. Fair Deal requires the private sector employer to provide a pension scheme which is broadly comparable to the public service scheme. Although it was widely anticipated that Fair Deal might be axed, thus reducing the cost of outsourcing for private sector employers, H M Government confirmed just before the end of 2011 that due to agreement being reached with the unions elsewhere on public sector pension reform it will now be possible to retain the Fair Deal policy protecting public sector pensions on staff transfers. It seems therefore that the previously anticipated reduction in outsourcing costs associated with the removal of Fair Deal will not now materialise. HM Treasury will respond formally to the Fair Deal consultation early in 2012.

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