

# SubCon

TRAINING WORKSHOPS  
MARCH 30-31, 2017 • DULLES, VA



# Sourcing Issues in International Subcontracting

## ***Breakout Session #A06***

Jim Kirlin, President, Kirlin Consulting, LLC

Allie Stanzione, Senior Contracts Manager, General Dynamics

March 30, 2017

10:30 a.m. – 12:00 p.m.

# Purpose

- Know the Sourcing issues in International Subcontracting
- Know the Pricing issues in International Subcontracting
- Know the Subcontract Management issues in International Subcontracting

# Agenda

- Why International Subcontracting is Important
- International Subcontracting Risk
- Sourcing issues in International Subcontracting
- Pricing issues in International Subcontracting
- Subcontract Management issues in International Subcontracting
- Case Study

# Why International Subcontracting is Important

- International subcontracting has grown significantly as primes turn to foreign customers for business and to foreign suppliers to get the best from their supply chain
- International subcontracting:
  - Is now required for world class performance
  - Is much harder than domestic subcontracting
  - Involves substantial third party risks
- A company must master international subcontracting skills to succeed today

# Why International Subcontracting is Important

- World-class technology
- Rare raw materials
- Affordable labor or manufacturing
- Offset credit

# Why International Subcontracting is Important

Increased Transparency on the Spend

- *Who?*
- *What?*
- *Where?*
- *How?*



} In-house

} Subcontracting

# Why International Subcontracting is Important

- My experience
  - International subcontracting is three times harder
  - International subcontracting takes additional skills
  - International subcontracting takes more time
  - International subcontracting is much riskier



# International Subcontracting Risks

- Identification of the risks inherent in the international subcontracting is the crucial first step to managing risk.
  - ***Goal today: Awareness (identification) of risks that are different than domestic subcontracting***
- Once risks are identified, manage risks by:
  - Accepting,
  - Avoiding,
  - Mitigating, or
  - Transferring

# Due Diligence

- The subcontract manager must exercise extra due diligence in selecting international subcontractors.
- She may have less information about a foreign subcontractor than a domestic subcontractor.
- It may be necessary to obtain consultants, legal advice, or local country experts in that country to advise on the responsibility and qualifications of international subcontractors.

# Sourcing Issues

- Antiboycott Regulations
- Political Contributions, Fees and Commissions, Contingency Fees (suppliers, agents and representatives)
- Corruption
- U.S. Export and Import Licenses
- Foreign Government License Requirements
- Human Trafficking
- Conflict Minerals
- If U.S. Government is Customer

# Antiboycott Regulations

- Antiboycott Laws under the Export Administration Act.
- Those laws discourage, and in some circumstances, prohibit U.S. companies from furthering or supporting the boycott of Israel sponsored by the Arab League, and certain other countries, including complying with certain requests for information designed to verify compliance with the boycott.
- Objectives: The antiboycott laws were adopted to encourage, and in specified cases, require U.S. firms to refuse to participate in foreign boycotts that the United States does not sanction. They have the effect of preventing U.S. firms from being used to implement foreign policies of other nations which run counter to U.S. policy.
- Violations can result in fines, imprisonment, and loss of their privilege to export.

Treasury website and Contract Management Body of Knowledge (CMBOK), NCMA, 4TH Edition, p. 42

# Political Contributions, Fees and Commissions, Contingency Fees (suppliers, agents and representatives)

- The International Traffic in Arms Regulations (ITAR) Part 130 requires the reporting of political contributions, fees or commissions when the prime contract is for the foreign sale of defense articles or services that is over \$500,000 under a Foreign Direct Commercial sale or a Foreign Military Sale contract.
- The prime has a duty to report to the Government customer.
- The prime also has a duty to collect the information from subcontractors for the sale of defense articles or defense services valued in an amount of \$500,000.

[http://www.pmdtcc.state.gov/regulations\\_laws/documents/official\\_itar/2013/ITAR\\_Part\\_130.pdf](http://www.pmdtcc.state.gov/regulations_laws/documents/official_itar/2013/ITAR_Part_130.pdf)

# Political Contributions, Fees and Commissions, Contingency Fees (suppliers, agents and representatives)

- The prime requires the subcontractor to certify to the following information:
  - The amount of each political contribution paid, or offered or agreed to be paid, or the amount of each fee or commission paid, or offered or agreed to be paid;
  - The date or dates on which each reported amount was paid, or offered or agreed to be paid;
  - The recipient of each such amount paid, or intended recipient if not yet paid;
  - The person who paid, or offered or agreed to pay such amount; and
  - The aggregate amounts of political contributions and of fees or commission, respectively, which shall have been reported.

[http://www.pmdt.state.gov/regulations\\_laws/documents/official\\_itar/2013/ITAR\\_Part\\_130.pdf](http://www.pmdt.state.gov/regulations_laws/documents/official_itar/2013/ITAR_Part_130.pdf)

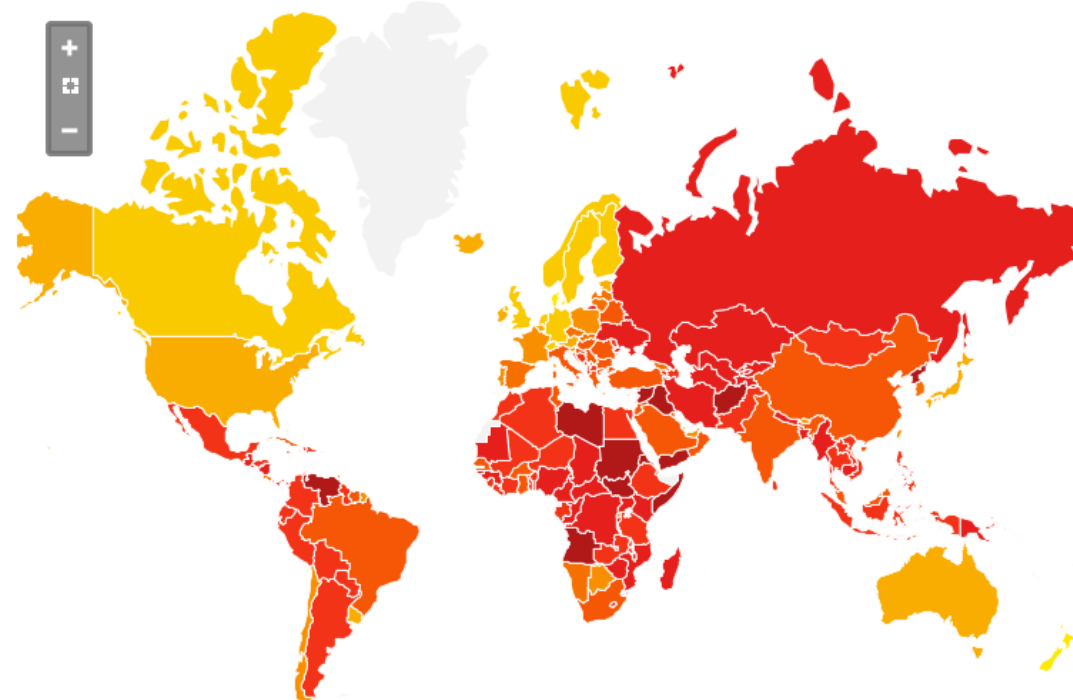
# Corruption

- The subcontract manager should exercise due diligence in dealing with subcontractors in certain countries due to corruption in the public sector of those countries.
- The Corruption Perceptions Index ranks countries and territories based on how corrupt their public sector is perceived to be.
- A country or territory's score indicates the perceived level of public sector corruption on a scale of 0 - 100, where 0 means that a country is perceived as highly corrupt and 100 means it is perceived as very clean.
- No country has a perfect score, and two-thirds of countries score below 50. This indicates a serious, worldwide corruption problem.

# Corruption Perceptions Index

It's a **Red** World

## CORRUPTION PERCEPTIONS INDEX 2016



 **TRANSPARENCY INTERNATIONAL**  
the global coalition against corruption



# Foreign Corrupt Practices Act (FCPA)

- The subcontract manager ensures all subcontracts require the subcontractor to comply with all laws, special emphasis should be given to the Foreign Corrupt Practices Act.
- Extra due diligence is communicating the key requirements of the FCPA will make a foreign subcontractor aware of their obligations.
- The FCPA is a U.S. federal law that prohibits corrupt payments to the foreign officials for the purpose of obtaining or keeping business.
- The act makes certain payments to foreign government officials illegal, even if such payments are legal or a common practice in the foreign country.
- *Be aware of the requirement to also comply with the foreign country's anti-corruption laws.*

Institute for Supply Management (ISM) Glossary of Key Supply Management Terms, Fourth Edition, 2006, p. 76

Desktop Guide to Basic Contracting Terms, Seventh Edition, National Contract Management (NCMA), p. 124

# Export and Import Licenses

- Exporting and importing requires compliance with the export and import requirements of both the prime's country and the subcontractor's country.
- The prime will want the subcontractor to comply with the prime's export and import laws.
- The subcontractor will want the prime to comply with the subcontractor's import and export laws.

# U.S. Export and Import Licenses

- The subcontract manager must ensure the prime has obtained a license from the U.S. Government before exporting certain articles, data or services in relation to the performance of the subcontract.
- This is especially important when the prime needs to disclose technical information or provide assistance to the subcontractor during the performance of the subcontract.
- The length of time to obtaining these licenses can be significant and must be planned for to avoid bringing the procurement to halt while waiting for the approval of the necessary licenses.

# U.S. Export and Import Licenses

- There are two key regulations to obtain U.S. Government licenses.
- The first is the International Traffic in Arms Regulation (ITAR).
- The State Department's Office of Defense Trade Controls (DTC) controls all exports of defense articles, related technical data, and services by issuing licenses and approvals.
- The U.S. Munitions List, located in Part 121 of the ITAR, details the items subject to DTC control.
- The ITAR also provides instructions on the procedures and types of licenses required. Violations of the ITAR can result in substantial civil fines and willful violations can result in criminal penalties including up to 10 years of imprisonment and fines up to \$1 million.

Desktop Guide to Basic Contracting Terms, Seventh Edition, National Contract Management (NCMA), p. 151

# U.S. Export and Import Licenses

- The second is the Export Administration Regulations (EAR).
- Export of commodities not regulated by the State Department through the ITAR are administered by the Commerce Department through the EAR.
- Under the EAR, most commodities can be exported under the authority of a general license.
- Authority to export commodities that are dual-use items (those that can be used for both defense/spacecraft and commercial purposes) is sought under a validated license.
- A validated license is necessary to protect national security or foreign policy interests, or because the commodity is in short supply in the United States.

Desktop Guide to Basic Contracting Terms, Seventh Edition, National Contract Management (NCMA), p. 113

# Foreign Government License Requirements

- Your foreign subcontractor may require a license from their country to export information or material to you.
- It takes them time to obtain this license.
- Foreign subcontractors usually require your company's cooperation, including signing an End-User Certificate so that the subcontractor can obtain an export license from its government.
- Typically, the subcontract will not “come into force” (be effective) until the license has been approved by the foreign government.
- Once you have information or material controlled by a foreign export license, you must control it IAW foreign license requirements (and potentially U.S. export control requirements, see your export/import and legal advisors).

# Human Trafficking

- The United States Government has adopted a policy prohibiting trafficking in persons including the trafficking-related activities of the clause



# Conflict Minerals



- Dodd-Frank Act (2010), Section 1502
  - Requires certain companies to disclose their use of conflict minerals if those minerals are “necessary to the functionality or production of a product” manufactured by those companies. Under the Act, those minerals include tantalum, tin, gold or tungsten.
  - Concerns that the exploitation and trade of conflict minerals by armed groups is helping to finance conflict in the Democratic Republic of Congo (DRC) region and is contributing to an emergency humanitarian crisis.



# If U.S. Government is Customer

- The subcontract manager should carefully review the prime contract for other restrictions, especially those clauses related to FAR Part 25 Foreign Acquisition and the agency supplements to FAR Part 25 Foreign Acquisitions as there are numerous requirements dealing with subcontracted work from a foreign source.
- Country of Origin Restrictions
  - Buy American (evaluation preference for “domestic end product”)(FAR 25.1)
  - The Trade Agreements Act (“designated countries”)(FAR 25.4)
  - The Berry Amendment (“specialty metals”)
- Excluded, Debarred, and Suspended Parties
- Restrictions on Certain Foreign Purchases
- Disclosure of Ownership or Control by a Foreign Government or by a Government of a Terrorist Country.

# Restrictions on Certain Foreign Purchases

- The FAR clause 52.225-13 Restrictions on Certain Foreign Purchases is used in all contracts unless an exception applies.
- Although this clause is in almost all subcontracts, special attention should be paid to this clause when the dealing with a foreign subcontractor to ensure their understanding and compliance.
- The prime is prohibited from subcontracting to certain sources and must flow down the requirement to the subcontract which must then be flow down to all subcontracts.

# Restrictions on Certain Foreign Purchases

## Clause 52.225-13 Restrictions on Certain Foreign Purchases (June 2008)

- (a) Except as authorized by the Office of Foreign Assets Control (OFAC) in the Department of the Treasury, the Contractor shall not acquire, for use in the performance of this contract, any supplies or services if any proclamation, Executive order, or statute administered by OFAC, or if OFAC's implementing regulations at 31 CFR Chapter V, would prohibit such a transaction by a person subject to the jurisdiction of the United States.
- (b) Except as authorized by OFAC, most transactions involving **Cuba, Iran, and Sudan** are prohibited, as are most imports from **Burma or North Korea**, into the United States or its outlying areas. **Lists of entities and individuals** subject to economic sanctions are included in **OFAC's List of Specially Designated Nationals and Blocked Persons** at <http://www.treas.gov/offices/enforcement/ofac/sdn>. More information about these restrictions, as well as updates, is available in the OFAC's regulations at 31 CFR Chapter V and/or on OFAC's website at <http://www.treas.gov/offices/enforcement/ofac>.
- (c) **The Contractor shall insert this clause, including this paragraph (c), in all subcontracts.**

# Disclosure of Ownership or Control by a Foreign Government or by a Government of a Terrorist Country

- The subcontract manager must ensure subcontractors certify ownership status under most Department of Defense prime contracts.
- The DFARS has two clauses that require disclosure of ownership as follows:
  - 252.209-7001 Disclosure of Ownership or Control by the Government of a Terrorist Country
  - 252.209-7002 Disclosure of Ownership by a Foreign Government
- If there are any issues raised by the subcontractor's disclosures and certifications, the subcontract manager provides the information to the prime's contracting organization which forwards the information to the Government for resolution.

# Pricing Issues

- Truthful Cost or Pricing Data (TINA for DoD) from Foreign Firms
- Auditing of Foreign Firms
- Customs and Duties
- Taxes
- Foreign Exchange Risk

# Truthful Cost or Pricing Data (TINA for DoD) from Foreign Firms

- Flow down clause as required.
- Being a foreign firm is not one of the exceptions to providing certified cost or pricing data when the law applies.
- Educate your foreign suppliers.
- Ensure they understand the consequences of defective cost or pricing data.

# Auditing of Foreign Firms

- Foreign subcontractors, like domestic subcontractors, resist or limit audits by primes.
- Foreign firms may also be part state-owned, which may further limit access.
- If under a U.S. Government contract, assist audits:
  - May be subject to agreements between U.S. Government and the foreign country.
  - May take much longer and may not be timely.
  - May have much less useful information.

# Customs and Duties

- The subcontract manager needs to be aware of whether foreign supplies are exempted from duties and whether the price of the subcontracts should or should not include duties.
- United States laws impose duties on foreign supplies imported into the customs territory of the United States.
- All shipments of imported supplies purchased under Government contracts are subject to the usual customs entry and examination requirements.
- Unless the agency obtains an exemption those shipments are also subject to duty.

FAR 25.9



# Customs and Duties

- Certain exemptions from these duties are available to Government agencies.
- Agencies must use these exemptions when the anticipated savings to appropriated funds will outweigh the administrative costs associated with processing required documentation.
- Subchapters VIII and X of Chapter 98 of the Harmonized Tariff Schedule of the United States (19 U.S.C. 1202) list supplies for which exemptions from duty may be obtained when imported into the customs territory of the United States under a Government contract.
- For certain of these supplies, the contracting agency must certify to the Commissioner of Customs that they are for the purpose stated in the Harmonized Tariff Schedule (see 19 CFR 10.102-104, 10.114, and 10.121 and 15 CFR Part 301 for requirements and formats).
- The prime contract may include FAR 52.225-8 Duty-Free Entry which is shown below and which the subcontract manager and the subcontractor must be aware of.
- The subcontract manager must ensure the Government is notified, prepare documents (with the help of the import organization) the shipping claiming duty free entry, and flowing down the clause as required.

FAR 25.9

# Taxes

- Taxes can be complicated in an international environment.
- It is not just a simple matter of who should pay which taxes.
- Often there are other considerations about which transactions constitute a taxable event.
- The best advice is to consult the finance department.

# Foreign Exchange Risk

- Working with a foreign subcontractor raises the issue of foreign exchange risk.
- The prime has to determine if the pricing will be in U.S. dollars or the foreign subcontractor's own currency.
- While it may seem preferable to always proposals and subcontracts stated in U.S. dollars, there is the possibility that the subcontractor, in assuming the foreign exchange risk, will be conservative in the pricing of the risk which may result in the higher prices.
- The subcontract manager can find past and projected currency exchange rate information and/or consult with the company's treasury department in determining the best strategy, which may including currency hedging.

# Subcontract Management Issues

- Laws
- Disputes Process
- Requirements Standards
- English Language
- Cultural Differences
- Time Zone and Work Day Differences
- Holiday Differences
- Travel
- Electronic Communication
- Shipping
- Incoterms
- Customs Documentation
- Offsets
- Letters of Credit

# Laws

- Domestic Subcontracts
  - Generally, based on a version of Uniform Commercial Code, which is based on English Common Law
  - Except Louisiana has differences
- International View of Contracts
  - English Common Law
    - Case law matters, judges active
    - Examples: U.S., U.K., Canada, Australia, India
  - Civil Law
    - Fixed Code and Statutes
    - Examples: France, Napoleonic code countries
  - Mixture

# Laws

## U.N. Convention on Contracts for the International Sale of Goods (CISG)

- The purpose of the CISG is to provide a modern, uniform, and fair regime for contracts for the international sale of goods. Thus, the CISG contributes significantly to introducing certainty in commercial exchanges and decreasing transaction costs.
- The adoption of the CISG provides modern, uniform legislation for the international sale of goods that would apply whenever contracts for the sale of goods are concluded between parties with a place of business in contracting states. In these cases, the CISG would apply directly, avoiding recourse to rules of private international law to determine the law applicable to the contract, adding significantly to the certainty and predictability of international sales contracts.

Contract Management Body of Knowledge (CMBOK), NCMA, 4<sup>TH</sup> Edition, p. 40

# Laws

- Clearly state the laws that apply.
- Clearly state that U.N. Convention on Contracts for the International Sale of Goods (CISG) does not apply if it is not being used.

# Disputes Process

- Method
  - Litigation in court
  - Alternate Disputes Resolution (nonjudicial)
  - Well-known international methods or conventions.
- Where (venue)
  - The subcontractor may take exception to the requirement to settle disputes in the United States.
  - A possible compromise is to use a neutral country



# Requirements Standards

- Use of international standards reduces costs and increases understanding of the requirements.
- Foreign subcontractors prefer to bid to the standards they are most familiar with and compliant to.
- Be aware of how U.S. standards are or are not comparable to foreign country, regional or European Union, etc. standards.

# English Language

- The subcontract should require that the subcontract and all matters related to the subcontract including deliverables and disputes be in the English language.
- When a subcontractor's original specification, design or other document is in a foreign language, the subcontract should require that the document be translated into English.
- Conducting meetings in English does not mean there will be complete understanding.
- The subcontractor's English skills may not be proficient so there may be difficulty in communications.
- Further, cultural barriers may prevent the subcontractor from admitting they don't understand.
- A good technique is to ask the subcontractor to state what they heard and what they understand to see if the communication has been received as intended.

# Cultural Differences

- Both the prime and subcontractor need to be aware of the cultural differences of the other.
- The concepts of time, authority, decision making, best efforts, admitting mistakes, face saving, emotion, etc. vary by culture and can significantly impact the way business is conducted between the parties.
- The subcontract manager has to adapt her management style to the one most effective for each culture.
- However, adapting for cultural differences does not mean forgetting about the subcontract requirements.
- The subcontract manager has the duty to require the subcontract to be fulfilled in accordance with the terms and conditions.
- Therefore, any adaptations need still be consistent with the subcontract so there is no ambiguity between the written word and the management approach and actions.

# Time Zone and Work Day Differences

- The differences in time zone can provide challenges in managing the subcontract.
- There may be very little overlap between the business days to have conversations and meetings.
- An early morning in the United States is needed to dialog with the subcontractors in Europe and the Middle East.
- A late afternoon meeting in the United States is needed for subcontractors in the Pacific who will be starting the next day.
- Differences on the days of work during the week can have a significant impact on the management of the effort and when deliveries are due.

# Holiday Differences

- Cultural Sensitivity
  - Recognition of prime's holidays
  - Recognition of subcontractor's holidays
- Impact on contract activities
  - Communications
  - Reviews and visits
  - Inspection and acceptance
  - Delivery schedule

# Travel

- There is usually less face-to-face interaction with foreign subcontractors.
- International travel is difficult and expensive.
- Visa and passport arrangements must be made many months in advance.
- The flying time and the jet lag tend to make travel less frequent.
- The length of the business agenda tends to be longer with multiple objectives.
- Consider splitting the distance when on-site visit is not required.

# Electronic Communication

- Emails are essential for international communication as they allow time-shifted communications and can carry a great deal of information.
- Encrypted emails and subcontract erooms can be used to protect ITAR information. Be extremely careful and document these exports and imports.

# Shipping

- The shipping time of goods is usually longer due to the length of travel, the multi-party logistics system needed for international shipments, and for the time to clear customs.
- Delivery schedules must take this time into account.
- The shipping and customs paperwork must be accurate to avoid delays in customs.
- The subcontract manager usually provides the shipping instructions to the subcontractor.
- The subcontract manager must work the issues causing any delays with the help of export, import and logistics personnel.



# Incoterms

- Instead of using the Uniform Commercial Code (UCC) shipping and delivery terms, international shipping typically uses INCOTERMS.
- INCOTERMS is a trademark of the International Chamber of Commerce and stands for International Commercial Terms.
- They were developed by the ICC as a uniform set of rules to clarify the costs, risks, and obligations of buyers and sellers in international commercial transactions.
- Specifically, they allocate the responsibilities for transportation costs, customs fees and documentation requirements, risks of loss or damage, insurance, and other responsibilities.

International Chamber of Commerce (ICC), Introduction to INCOTERMS2010, <http://www.iccwbo.org/products-and-services/trade-facilitation/incoterms-2010/the-incoterms-rules/>

# Incoterms

- The INCOTERMS are not:
  - International law
  - Payment terms
  - Title and ownership terms
  - A way around export laws

International Chamber of Commerce (ICC), Introduction to INCOTERMS2010, <http://www.iccwbo.org/products-and-services/trade-facilitation/incoterms-2010/the-incoterms-rules/>

# Customs Documentation

- There are a lot of documents that are required to export and import goods.
- The documentation must be perfect for the shipment to clear.
- Problems in customs due to documentation can significantly delay deliveries.
- This documentation is the evidence for compliance with export/import licenses.
- Customs expertise is a must for international subcontracting.

# Offsets

- When the prime uses a foreign subcontractor, the prime may obtain a credit to its offset obligation to the foreign customer.
- An offset arises when the prime agrees to a foreign customer's (typically a foreign government) requirement that the prime must purchase from the foreign country's suppliers.
- Offsets in defense trade encompass a range of industrial compensation arrangements required by foreign governments as a condition of the purchase of defense articles and services from non-domestic suppliers.
- This mandatory compensation can be directly related to the purchased defense article or service or it can involve activities or goods unrelated to the defense sale.
- The subcontract manager must ensure that the subcontract states that the prime will be able to use the subcontracted effort in fulfillment of the prime's offset obligations.

Offsets in Defense Trade, Sixteenth Study, U.S. Department of Commerce, Bureau of Industry and Security, January 2012, p. 1

# Letters of Credit

- **Payment to Subcontractor**
  - A letter of credit is usually thought of a document that assures the seller that payment will be made by the bank issuing the letter of credit upon fulfillment of the terms of the sales agreement.
  - The subcontractor must provide the evidence of performance exactly as stated in the letter of credit in order for the bank to make a payment.
- **Performance by Subcontractor**
  - However, the buyer may require a standby letter of credit or a performance bond guaranteeing the seller's performance.
  - The value of the standby letter or credit or performance bond might be 5% to 10% of the subcontract value with a lesser amount during a warranty period.
- The letter of credit is separate from the subcontract and the bank pays in accordance with the terms of the letter of credit and does not look to the language of the subcontract.

Contract Management Body of Knowledge (CMBOK), NCMA, 4TH Edition, p. 177

# Letters of Credit

- Examples of Common International Models
  - ICC Uniform Customs and Practice for Documentary Credits - UCP 600
  - ICC ISP 98- International Standby Practices
  - The United Nations Commission on International Trade Law (UNCITRAL) Convention on Independent Guarantees and Stand-by Letters of Credit (1995)

# Purpose

- Know the Sourcing issues in International Subcontracting
- Know the Pricing issues in International Subcontracting
- Know the Subcontract Management issues in International Subcontracting

# Agenda

- Why International Subcontracting is Important
- International Subcontracting Risk
- Sourcing issues in International Subcontracting
- Pricing issues in International Subcontracting
- Subcontract Management issues in International Subcontracting
- Case Study



# Case Study

- Time

- Introduction of case: 4 minutes
- Discuss and record concerns: 10 minutes
- Share concerns with session: 16 minutes
- Total time for case study: 30 minutes

# Case Study

**Use the worksheet to record your concerns**

	Issues	Concerns
1	The subcontract is in French at the request of the subcontractor.	
2	The information and assistance that you are required to give to the subcontractor is subject to U.S. export laws. The subcontractor will need this information and assistance one month after subcontract award. The subcontractor will use workers who are citizens of Pakistan and India.	
3	The item that the subcontractor will produce is subject to French export laws. The subcontractor requires you and the U.S. Government to sign an End-User Certificate. The subcontractor cannot proceed until this is provided.	
4	A weekly telecon is planned for 10 a.m. Eastern time on Friday.	
5	A one-week program and design review will be held in Paris starting on August 15th.	
6	Your quality assurance personnel will inspect and accept the units at the subcontractor's location.	
7	Deliveries are 10 units per month, on 25th of each month, starting in November and going through September. Early delivery is not allowed.	
8	The subcontractor is required to deliver the units to your location within three days of your quality assurance person accepting the units.	
9	Payments to the subcontractor will be made in Euros.	

Thank You!

