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## European Court of Justice Mandates Broader Use of Competitive Tendering in Defense Procurement

A landmark ruling of the European Court of Justice (ECJ) has significantly restricted the ability of EU governments to use sole-source or negotiated procedures with selected suppliers for purchases of defense and security equipment. In a case concerning the purchase by the Finnish Defence Forces Technical Research Centre of electromagnetic testing equipment for use in simulated combat situations, the ECJ ruled that procurement agencies must use the competitive tendering procedures laid out in the EU public procurement directives unless (1) the supplies have been specially designed and developed, or substantially modified, for military use; and (2) the procurement involves an essential national security interest that cannot be addressed within a competitive tendering procedure.

This most recent case further cements the procedures aggrieved bidders now have to challenge the award of a contract for defense supplies made otherwise than through a competitive tendering process, unless the purchasing authority can demonstrate that the procurement meets both these conditions for an exemption from the EU's public procurement procedures.

**The New EU Defense Procurement Regime** In an effort to reduce the institutional "national preference" that prevails in defense and security programs in Europe, the 27 EU member states have adopted a package of legislative initiatives to promote greater transparency and international competition. The new rules limit the ability of national procurement authorities to avoid public tendering rules on grounds of national security. At the same time, the European Commission has signalled a willingness to challenge the imposition of discriminatory contract conditions, such as indirect off-sets and local content requirements, which violate the non-discrimination principles of EU competition law.

Perhaps most significantly for suppliers from outside Europe, the new legislative framework requires EU member states to have an effective bid protest procedure. Aggrieved bidders that have been the victims of unfair or discriminatory procurement procedures may now seek a remedy in the national courts of the procurement authority.

**The Obstacles to International Competition** Within the EU, there has historically been no body of government contract regulation for defense procurement analogous to the U.S. Federal Acquisition Regulations. The founding treaty of the European Union expressly excluded defense and security matters from the scope of Community law. Article 346 of the EU Treaty expressly reserves to each EU member state, the right 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.”

National governments have relied on the Article 346 exemption extensively to avoid competitive tendering rules that would otherwise have been mandated by EU law. In many countries, there has been a systematic use of the national security exemption to secure contracts for domestic suppliers for a broad range of military equipment requirements ranging from boots to bullets that raise no obvious national security concerns.

The European Commission found that less than half of EU member states conducted public tender processes for the procurement of non-military defense items such as uniforms, which clearly fall outside the intended purpose of Article 346. This number fell to only 25 member states for contracts for military goods.

**The European Commission's Response** The European Commission's response to these obstacles to greater competition is a legislative initiative known as the European Defence Package, which includes the Directive on Defence and Sensitive Security Procurement, and specifies new procedures for the procurement of defense and security equipment.

At the same time, the European Commission has published legislative guidance aimed at reducing reliance by national governments on the Article 346 national security exemption to avoid use of public tendering procedures that would otherwise be mandated by EU law. It has also shown, as demonstrated by this most recent case, a willingness to challenge tendering procedures for defense-related products where they fail to follow the correct public procurement rules and, in the absence of grounds that they are necessary to protect essential security interests, violate general principles of EU competition law.

**Directive on Defense and Sensitive Security Procurement** Current EU public procurement rules require that, with limited exceptions, qualifying contracts be awarded through a public tender process or other competitive procedure open to domestic and international suppliers. In most cases, the proposed contract award must first be advertised by the contracting authority inviting expressions

of interest. The authority is then required to adopt one of four different types of tender procedure that include both an open tender process and, for some categories of contract, a “negotiated procedure”. The negotiated procedure allows the contracting authority to select one or more prospective suppliers, and to establish the contractual terms through direct negotiation. The negotiated procedure may only be used in limited circumstances, for instance, where the product or service is only available from a small number of sources or a single source.

The Directive on Defence and Sensitive Security Procurement now extends features of the current EU-wide public procurement code to certain types of defense and security contract. It recognizes that, given their complexity and sensitivity, conventional open tender procedures are not an appropriate method for the award of contracts for defense and security items. Instead, the Directive permits contracting authorities to use the negotiated procedure (with prior publication of a contract notice) without having to provide prior justification. Absent a threat to essential national security interests, however, the exercise of the selection process must comply with the general non-discrimination principles of EU competition law.

The Directive permits restricted competition and non-competitive procurement procedures to be used, but only in limited prescribed circumstances. The UK Ministry of Defence has stated that it expects the majority of defense and sensitive procurements to be advertised through contract notices in the Official Journal of the EU.

The Directive governs all contracts for the supply of military equipment, certain sensitive security equipment, works and services for specifically military purposes, and sensitive works and sensitive services that have a value of €412,000 (US\$540,000) for supply and service contracts, and €5,150,000 (US\$6,754,00) for works contracts. In the non-military security field, including homeland security, the Directive will apply to public contracts meeting these value thresholds possessing characteristics similar to defense contracts, such as procurements related to the protection of borders, police activities and crisis management operations.

The Directive application to contracts involving intelligence equipment may be limited. It will not apply to contracts involving sensitive information which, if revealed, would threaten essential security interests.

Each EU member state was required to transpose the terms of the Directive into the national law by 21 August 2011. Most countries had either fully implemented by that date or had made substantial progress. The European Commission, which polices implementation, has adjudged that Germany, the Netherlands, Bulgaria, Slovenia and Luxembourg have failed to take sufficient steps to fully implement the new measure, and has either commenced or threatened to commence infringement proceedings against each of these member states.

**Non-Discrimination Obligation** The Directive includes an express statement of the principle of non-discrimination which binds contracting authorities in making contract awards:

**Contracting authorities/entities shall treat economic operators equally and in a non-discriminatory manner and shall act in a transparent way.**

This principle prohibits the use of any measures which have the effect of discriminating against any group of participants in a procedure. This prohibition will include, for example, a condition that imposes offset, compensation or any obligations only for non-EU bidders which are not also imposed on EU bidders. The rule also prohibits discrimination targeted at the bidder's own supply chains by, for instance, requiring local content without objective justification.

**The National Security Exemption** The Directive does not remove the right of national governments under Article 346 to exclude a particular contract from the mandatory procurement procedures on grounds of national security, under which the Finnish Defence Force sought to avoid the use of a competitive tendering procedure. It will, however, limit use of the exemption to cases where the authority can show that the tender processes contained in the procurement Directive are not sufficient to safeguard essential security interests.

In an attempt to clarify the scope of the exemption, the European Commission has published an Interpretative Communication providing its interpretation of Article 346. This guidance document, which reflects EU case law, provides that application of Article 346 to defense procurement is subject to the following conditions:

- Use of the exemption must be necessary for the protection of member states' essential security interests
- Only the protection of essential security interests justifies an exemption (other interests such as economic and industrial interests are by themselves not sufficient)
- The security interests at stake must be "essential," which implies that the exemption is only available for defense procurement contracts that are of highest importance for member states' military capabilities

It will be for the contracting authority to make an assessment of whether the Article 346 exemption is available on a case-by-case basis. If, however, a contracting authority elects to rely on Article 346, the European Commission may require the relevant member state to furnish evidence to justify its use. It can also challenge that use in the European Court of Justice if it considers that a member state is making improper use of Article 346. It will then be for the contracting authority to prove that the use of the exemption is necessary for the protection of its essential security interests.

**Recent European Court of Justice Interpretation** Although initiated prior to the implementation of the EU Directive on Defence and Sensitive Security Procurement, the ruling by the European Court of Justice concerning the procurement of testing equipment the Finnish Government illustrates the remedies available to losing bidders to challenge defense procurements on grounds of discrimination or other irregularity in the procurement process.

In 2008, the Finnish Defence Forces Technical Research Centre issued a call for tenders for tiltable turntable equipment to be used for electromagnetic measurement and testing of electrical equipment in simulated combat situations having a value of €1.65 million (US\$2.09 million). The procurement authority did not publish notice of the tender in the Official Journal of the European Union or comply with the other formal requirements of the EU public procurement regulations (EU Directive 2004/18). The Finnish Government took the position that the procurement fell within the scope of the Article 346 exemption for defense equipment.

One of the unsuccessful bidders, Insinööritoimisto InsTiimi Oy (InsTiimi) challenged the contract award in the Finnish Markkinaoikeus (Market Court) on grounds that the procurement was not exempt from the procurement regulations requiring a competitive tender process, and that the Finnish Government has improperly relied on the Article 346 exemption. The Finnish national court referred the question to the European Court of Justice.

The ECJ made two significant findings regarding the conditions to be satisfied before a contracting authority can properly rely on Article 346 to avoid the competitive tendering procedures laid out in the EU public procurement regulations:

- The equipment or technology must be specially designed and developed or substantially modified for military use. In the case of equipment having dual military and commercial uses, the intended application and use by the procurement authority is irrelevant.
- Even where the products have been specially designed and developed for military use and have no commercial application, the procurement authority must be able to establish that the use of the derogation provided by Article 346 is necessary to protect its essential security interests, and those essential interests could not have been addressed within a competitive tendering procedure

**European Commission Investigations** The European Commission can also investigate contract awards either following a complaint from aggrieved bidders or on their own initiative. By way of further example, the European Commission opened an investigation into the purchase by the Czech Republic of four military transport aircraft in 2009. The Czech authorities awarded the contract through

a sole-source process, disregarding the tendering procedures mandated by the EU public procurement code relying on the Article 346 derogation. The European Commission closed the case in November 2011 on the grounds that the contract had already been fully performed, but obtained undertakings from the Czech government that it will in the future limit its use of the Article 346 exemption to exceptional cases where it is necessary for the protection of its essential security interests. The Czech government also acknowledges that EU member states that make use of the Article 346 derogation must prove that this measure is necessary for the protection of their essential security interests if the European Commission requires them to do so. This case represented a warning shot for all procurement authorities that continue to abuse their reliance on Article 346 to avoid the tendering procedures mandated by EU law.

**Bid Protests** In contrast to the position in the United States, challenges by aggrieved bidders of defense contract awards are very rare in Europe. This is, in part, because of the nature of the relationship between national defense ministries and their favored suppliers, the reluctance of contractors to sue their largest customer, and the absence of a judicial review procedure tailored to the defense sector. The new regulations implementing the EU Directive on Defence and Sensitive Security Procurement have introduced a potentially important change – both for domestic contractors and prospective suppliers from other countries.

Contracts awarded under the Directive's procedures will be subject to the review procedures established by the EU Remedies Directive (which came into force in 2008). This measure requires the awarding authority to wait for a specified number of days following contract award before signing the contract. This "standstill period" gives rejected bidders the opportunity to commence a review procedure in the national courts of that authority.

The Directive also requires member states to establish clear and effective procedures to enable aggrieved bidders to seek redress in cases where contracts have been unfairly awarded. Local courts are empowered to set aside contracts where the mandated tender procedures have not been followed, and to require retendering. It remains to be seen whether the Finnish Markkinaoikeus will set aside the contract award in the case brought by InsTiimi following clarification on this issue from the ECJ.

In order for an aggrieved bidder to avail itself of the contract award process under the new EU Directive, the bidder must be "a national of and established in [an EU member state]". Prospective U.S. bidders wishing to preserve their rights to review a contract award should, therefore, submit their tenders through a subsidiary incorporated in one of the EU member states.

**Impact** It remains to be seen whether the European Defence Package will succeed in breaking down the long-standing and cosy relationships between national governments and their favored domestic suppliers that currently characterize the European defense market. The prospect of a greater transparency may yet prove to be an illusion. The success of the new measures in achieving greater competition is going to depend upon the willingness of both the European Commission and individual bidders to challenge the continued reliance by contracting authorities on the Article 346 national security exemption.

Bidders excluded from a contract opportunity limited to domestic suppliers on grounds of national security now have a clear legal basis for challenging that decision and any subsequent contract award. The contracting authority can be put to the burden of proving that the use of the negotiated procedures mandated by the procurement Directive are not sufficient to safeguard essential security interests.

But perhaps the most significant impact of the package will be the imposition of the European Commission's oversight over national defense procurement decisions. A defense minister's discretion regarding procurement awards will now become subject to continual review and possible challenge from Brussels. The threat of such intervention may be sufficient incentive to open more large procurements to international competition.