

Managing business and legal risks in the defence sector

Impact of Covid-19 on the MENA defence industry
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Despite the strength and resilience of the defence industry, it is not immune to the effects of COVID-19. How companies in or associated with the sector adapt to the new circumstances and manage their business and legal risks could make the difference between those who fail, survive and thrive.

The defence sector is being shielded from the worst effects of the pandemic because of its strategic importance, with governments across the globe continuing their existing defence programmes, many of which are typically long term in nature. For example, Lockheed Martin has recently been awarded:

- a \$4.7bn contract modification for 78 F-35 Lightning II Joint Strike Fighters (according to a contract announcement by the US Department of Defence); and
- an extra \$932m to supply intermediate-range interceptor missiles to the US and Saudi Arabia.

Defence ministries have also been proactive in confirming their continuing commitment to suppliers. For example, the UK Ministry of Defence (MoD), when explaining to its core defence contractors how emergency COVID-19 measures would apply, emphasised that ‘it is vital that critical Defence operations and programmes, on which our nation relies, continue uninterrupted’.

In the MENA region, governments’ defence spending commitments in, for example, the UAE and Saudi Arabia, have remained robust due to the fact that they engage large contracts with other governments or foreign manufacturers as in the case of foreign military sales.

Risks and challenges defence sector companies are facing due to COVID-19

Despite the resilience of the sector, the impact of COVID-19 on defence supply chains cannot be overlooked. For example:

- Spanish shipbuilder Navantia, which signed a \$991m deal with Saudi Arabian Military Industries in September 2019 to adapt combat management systems for Saudi ships, has reduced activity to the bare minimum, potentially impacting delivery schedules; and Thales has enacted a ‘global crisis adaption plan’,
- which defers spending on non-critical investments but maintains critical and strategic client services.

Notably however, some defence supply chains have been less affected than others. For instance, the final assembly and checkout facility for F-35s in northern Italy re-opened after just a two-day shutdown, despite the fact that it

relies on a uniquely global network of parts suppliers. There are also other emerging risks, including defence companies varying, suspending or even terminating supply contracts as a result of COVID-19 under either certain clauses (eg force majeure or frustration) or statutory protections (the exact nature of which depend on the governing law). Meanwhile, with MENA’s defence sector moving to performance-based contracting, the effective management of contractual obligations has become even more important, especially for those companies providing ancillary technology and support services, such as maintenance.

Companies may also be facing workforce issues. Employees themselves may be suffering from COVID-19 while travel restrictions may prevent foreign workers employed with defence companies from returning to the Gulf region (although the UAE is beginning to ease such restrictions). As a result, companies are grappling with challenges around working from home, such as operating in different time zones and having access to only limited resources.

In addition, for foreign workers who remain out of the country for prolonged periods, their work visas may expire and, based on their activities, they could end up creating a permanent establishment in countries where their employer has no presence, which may have tax consequences.

It is important to set the impact of COVID-19 in the context of wider geopolitical trends too, most fundamentally the underlying retreat from globalisation. The effects of the US-China trade war, together with stringent US export controls and foreign investment restrictions, could create potential risks around blending of US and Chinese technologies.

We are also seeing the region’s competition and financial regulators continuing their work and so, despite some flexibility in terms of timing, the rules themselves still stand. Companies will therefore need to monitor carefully compliance risks, and any risks that may arise from contractual breaches during and in the immediate aftermath of the COVID-19 crisis.

Managing business and legal risks

To manage these risks, defence sector companies operating in MENA need to strategise, collaborate with home governments, and innovate.

For example:

- Some governments are taking proactive steps to protect defence manufacturers (eg Canada has re-negotiated a multi-billion USD contract with Saudi Arabia and lifted a freeze on licences for defence exports to the Kingdom).
- Government customers are intervening to ensure supplies are secured. For example, the UK MoD has released defence-sector-specific guidance on how contractors may support SMEs in their supply chains to maintain cash flow, ensure service continuity and protect jobs.

To prevent contractual breaches arising from COVID-19 effects, we are seeing some close collaborations between governments and manufacturers. For example, the EU has suspended the requirement to compete for defence contracts when it is in the interests of national security.

Similarly, in MENA, efforts are accelerating to build domestic defence supply chains. For example, Saudi Arabia is aiming to increase local military spending from the current level of 5 per cent to 50 per cent by 2030. Companies that capitalise on these opportunities when others may be focused more on immediate COVID-19-related issues may be more likely to prosper.

Economic stimulus programmes and other opportunities

Foreign defence companies in the region could seek to access and benefit from the economic stimulus packages introduced in Gulf countries in response to COVID-19. For example, the UAE central bank committed 50 billion dirhams to a zero-cost facility that provides financial relief to private sector companies, SMEs and individuals resident in the UAE. Other measures include reductions

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to interest rates and the extension of deadlines for the filing of tax returns.

Meanwhile, the Saudi government has announced a set of support packages targeting the private sector, totaling almost \$48 billion. The packages include: exemptions and the postponement of some government dues (\$18.6 billion); \$13.3 billion to support the banking and SME sectors; a \$13.3 billion allocation to ensure that government dues to the private sector are paid in a timely manner; and a wage subsidy of 60 per cent (up to SAR 9,000 per employee per month) of Saudi employees' salaries in the private sector, up to a ceiling of \$2.39bn. There are also numerous tax related-measures, including extending deadlines for filing tax returns and paying those taxes.

Conclusion

Despite the inherent strengths of the sector, defence companies – including those in the MENA region – are still feeling the effects of the geopolitical, economic and social fallout of the pandemic. So it is vital that defence companies think carefully about understanding the relevant business and legal risks, and putting appropriate measures in place to manage them and capitalise on the key opportunities the crisis presents.

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