WTO Panel Issues Ruling on Dispute Concerning US Measures Affecting Trade in Large Civil Aircraft

On March 31, 2011, a World Trade Organization (WTO) dispute settlement panel published its report on *United States—Measures Affecting Trade in Civil Aircraft (DS353)*. In this dispute the European Union challenged various US federal, state and local subsidies on the grounds that they were WTO inconsistent and benefited the aircraft manufacturer Boeing. One day after the report was published, the WTO Dispute Settlement Body (DSB) was notified that the EU planned to lodge an appeal.

This panel report is the second decision of two parallel WTO cases on large civil aircraft (LCA) initiated in 2004 by the European Union and the United States respectively, alleging illegal government support to their LCA manufacturers, Airbus and Boeing. On June 30, 2010, a WTO panel published its report on the US dispute brought against the European Union in the Airbus case (*European Union—Measures Affecting Trade in Large Civil Aircraft (DS316)*).

In the instant case, the European Union argued that the United States granted $23.7 billion in specific subsidies at the federal, state and local level to Boeing's LCA division. In particular, the EU claimed that at the state and local level, Washington, Kansas, Illinois and municipalities therein provided more than $800 million in benefits for Boeing and committed to provide $4 billion in additional benefits from 2007. The majority of these state and local incentives were in the form of export contingent tax incentives provided by Washington State tied to the production of Boeing's LCA division.

The European Union also asserted that, at the federal level, Boeing had received almost $17 billion in funding and support from NASA, the Department of Defense (DOD), the Department of Commerce (DOC) and the Department of Labor (DOL), with the bulk of this funding coming from numerous R&D programs at NASA and the DOD. In addition, the European Union claimed that the US government also provided approximately $2.2 billion in export-contingent tax relief to Boeing under the Foreign Sales Corporation (FSC)/Extraterritorial Income (ETI) tax exclusion regimes.

The European Union claimed that these funding and support measures were prohibited and actionable subsidies under the WTO Subsidies and Countervailing Measures (SCM) Agreement. In particular, the European Union claimed that the tax incentives provided by the state of Washington under legislation adopted in 2003, and the tax breaks provided by the US federal government pursuant to legislation concerning the FSC/ETI tax breaks, were prohibited subsidies under Articles 3.1(a) and 3.2 of the SCM Agreement. In addition, the EU claimed that all of the subsidies were actionable under the SCM Agreement and that by using these subsidies, the United States adversely affected EU interests in contravention of Article 5(c) of the SCM Agreement. The EU requested the

panel to recommend that the United States withdraw the prohibited subsidies without delay and take appropriate steps to remove the adverse effects.

The WTO panel upheld most of the EU's claims, although there was a great difference between the subsidized amount alleged and the amount found by the panel. The panel concurred with the European Union that the FSC/ETI tax exemption measures, as applied, constituted prohibited export subsidies. However, because the FSC/ETI measures were no longer in force with respect to Boeing, the panel abstained from making any recommendation. In addition, it did not make any additional recommendations as it considered that the recommendations of the preexisting DSB ruling and recommendations concerning these measures remained operative (Panel and Appellate Body Reports on *US-FSC*).

The panel also found that *some* of the measures constituted specific subsidies which amounted to $5.3 billion between the period of 1989 to 2006. These included some maintained by the states of Washington (Business and Occupation (B&O) tax reductions and tax credits), Kansas (Industrial Revenue Bonds) and Illinois (relocation expenses, reimbursement of headquarters, refunds/abatement of property taxes), and certain municipalities therein (Everett, Washington, Wichita, Kansas, Chicago, Illinois); the NASA aeronautics R&D measures; some of the DOD aeronautics R&D measures; and the FSC/ETI and successor act subsidies.

The WTO panel also found that some of the specific subsidies (i.e., the NASA and DOD aeronautics R&D subsidies, the FSC/ETI and successor act subsidies and the Washington state and municipal B&O tax subsidies) caused adverse effects to the EU's interests in the form of serious prejudice, finding that the effect of these subsidies was displacement and impedance (or threat thereof) of Airbus LCA from third-country markets, significant price suppression and significant lost sales. However, with respect to the Washington State tax incentives, the panel did not agree with the European Union that the subsidies were prohibited export subsidies. The panel, pursuant to Article 7.8 of the SCM Agreement, recommended that the United States take appropriate steps to remove the adverse effects or withdraw the subsidy.

One of the key questions addressed by the panel in its report was whether R&D measures were "purchase of services" as claimed by the United States and, therefore, excluded from the scope of Article 1 of the SCM Agreement. The European Union challenged eight NASA aeronautics R&D programs consisting of a number of procurement contracts and Space Acts Agreements between NASA and Boeing. The European Union claimed that these programs were in fact grants to Boeing for LCA-related R&D expenses. The United States claimed that the R&D programs were "purchases of services" outside the scope of Article 1.1(a) (1). Deciding for the first time on this issue, the panel stated that:

> Article 1.1(a)(1) is a definitional provision that sets forth an exhaustive, closed list ("…i.e. where…") of the types of transactions that constitute financial contributions under the SCM Agreement. The omission of the words "or services" in the context of a provision that sets forth an exhaustive, closed list of the kinds of transactions covered by the SCM Agreement only reinforces the implication that the parties intended to exclude purchases of services from the definition of "financial contribution" in Article 1.1(a)(1) of the SCM Agreement.

The panel made references to the preparatory work of Article 1.1(a)(1)(iii) and Article 14(d) of the SCM Agreement, which revealed that a reference to governmental "purchases of services" originally appeared in, and was subsequently removed from, the text of both of these provisions in the final draft, but the reference to purchases of "goods" was retained. In the panel's view, the preparatory work confirmed that the signatories intended to exclude "purchases of services" from the scope of Article 1.1(a)(1).

Therefore, the panel concluded that transactions *properly characterized* as "purchases of services" were excluded from the scope of Article 1.1(a)1(i) of the SCM Agreement.

When examining whether or not R&D contracts and agreements with Boeing were properly characterized as a "purchase of service," the panel stated that this depends on the *nature of the work* that Boeing was required to perform under the contracts (by examining the core terms of these contracts) and whether the R&D that Boeing was required to conduct was principally for its own benefit and use, or whether it was principally for the benefit and use of the US government (since the ordinary meaning of the concept service was that the work performed be for the benefit and use of the entity funding the R&D or unrelated third parties). In addition, the panel stated that focusing on whether the work performed was for the benefit of the government is consistent with prior GATT panels examined the question of whether the transaction was characterized as government procurement.

Based on the review of the evidence, the panel found that the work that Boeing performed under its aeronautics R&D contracts with NASA was principally for its own benefit or use, rather than for the benefit or use of the US government (or unrelated third parties), and that even if these contracts took the form of a governmental procurement of services, the totality of the evidence before the panel lead to the conclusion that the substance of these transactions cannot properly be characterized as a "purchase of services" for the purpose of Article 1.1(a)(1) of the SCM Agreement. Therefore, the panel found that the payments made to Boeing under these contracts were direct transfer of funds covered by Article 1.1(a)(1)(i) of the SCM Agreement, and further found that the access to NASA facilities, equipment and employees provided to Boeing through the R&D programs, constituted a provision of goods or services within the meaning of Article 1.1(a)(1)(iii) of the SCM Agreement. The panel concluded that the eight aeronautics R&D programs constituted specific subsidies within the meaning of Articles 1 and 2, and that estimates of the amount subsidized amounted to $2.6 billion between 1989-2006.

The European Union also challenged 23 R&D programs between Boeing and the DOD relating to dual-use technologies—that is, technologies applicable to both military and commercial aircraft. In determining whether they constituted subsidies, the panel examined whether they were properly characterized as "purchase of services." As mentioned in the report:

> More specifically, the Panel will consider, inter alia, the legislation authorizing the programmes at issue, the types of instruments entered into between DOD and Boeing, whether DOD has any demonstrable use for the R&D performed under these programmes, the allocation of intellectual property rights under these transactions, and whether the transactions at issue had the typical elements of a "purchase of services."

On the basis of this, the panel only found certain R&D programs (i.e., R&D assistance instruments) with the DOD to be for the benefit and use of Boeing itself, thereby constituting direct transfer of funds, and that the access to DOD facilities provided to Boeing under these agreements constituted a provision of goods and services.

In relation to the NASA/DOD R&D programs with Boeing, the European Union made a separate claim that the intellectual property rights transfered by NASA and DOD (i.e., patent rights, data rights and trade secrets) over research performed by Boeing during the R&D programs were subsidies within the meaning of Article 1 of the SCM Agreement.

With respect to the transfer of patent rights, the panel said that assuming that such transfer constituted a financial contribution conferring benefits, the EU had failed to demonstrate that the allocation of patent rights under NASA and DOD contracts was specific to a "group of

enterprises or industries" (defined by the panel to mean a sufficiently limited group). The reason given by the panel was that the allocation of patent rights is uniform under all US government R&D contracts, agreements and grants in respect of all US government departments and agencies for all enterprises in all sectors. This allocation policy has been implemented through a number of legal instruments; these instruments specify that the contractor or recipient is the owner of any inventions (i.e., patent rights) that it conceives during the course of performing research funded by the US government. Moreover, the US government is only entitled to a royalty-free "government use/purpose" license to use the particular invention.

In addition, the panel disagreed with the EU's reasoning that Boeing's retention of certain intellectual properties rights resulting from research that Boeing performed pursuant to those same R&D programs (already found to be financial contributions) could be treated as separate, additional financial contributions. The panel stated that the EU's analysis involves double-counting.

With respect to the EU's claims on prohibited subsides, the panel did not agree that the subsidies granted by Washington State were prohibited export subsidies. According to the panel, the European Union failed to demonstrate a tie between the grant of the subsidy and the actual or anticipated exportation, as required in footnote 4 of Article 3.1(a). In defining what was "actual," the panel took the view that actual exportation is:

> …exportation that must be realized or that must actually occur. This approach to the interpretation of "actual" exportation is supported by the ordinary meaning of the term, which is "existing in act or fact; real" and "in action or existence at the time, present; current". This is opposed to "anticipated" exportation, which is expected but may or may not in fact take place.

On April 1, 2011, the European Union notified the DSB of its intention to appeal the panel's report with respect to certain legal issues. Among other issues, the EU has indicated an intent to appeal (i) the panel's findings that "purchases of services' are excluded from the scope of the Article 1.1(a)(1) of the SCM Agreement, (ii) the panel's conclusion that the allocation of patent rights under NASA and DOD R&D programs with Boeing did not constitute specific subsidies as established in Article 2 of the SCM Agreement, (iii) the fact that the Washington State taxes were found not to be prohibited subsidies contingent in fact upon export, (iv) the panel's interpretation and application of Articles 5 and 6.3 of the SCM Agreement with respect to certain subsidies and (v) the panel's findings on the initiation of an Annex V of the SCM Agreement on the procedure for developing information concerning serious prejudice.

For more information about the matters raised in this Legal Update, please contact any of the following lawyers.

Duane Layton
+1 202 263 3811
dlayton@mayerbrown.com

Paulette Vander Schueren
+32 2 551 5950
PVanderSchueren@mayerbrown.com

Felipe Berer
Tauil & Chequer Advogados
+55 11 2504 4210
fBerer@mayerbrown.com