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## Bid-Rigging in South Korean Defense Procurement: The KSS-III Submarine Project Case Study

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In the complex landscape of global defense procurement, nations often find themselves navigating a delicate balance between fostering domestic capabilities and maintaining fair competition. A landmark case in South Korea's defense industry has brought this tension into sharp focus, offering valuable insights into the intricacies of antitrust regulation in the context of national security interests. The KSS-III submarine project case study not only illuminates the challenges faced by South Korea but also provides crucial lessons for the international defense community.

### Historical Context and Project Background

To fully appreciate the significance of the [KSS-III project](#), it is essential to understand its historical context. South Korea's submarine program began in 1989 with the KSS-I, a 1,200-ton vessel procured from Germany on a turn-key basis. This initial foray into submarine technology was followed by the KSS-II project in 2002, which involved domestic design work with German technical assistance. Both these earlier projects relied heavily on foreign-sourced Combat Management (CM) and Sound Navigation and Ranging (SONAR) systems, with installation, integration, and testing carried out by foreign engineers.

The KSS-III project, initiated as part of the Korean Navy's modernization program, represented a significant leap forward in South Korea's ambitions for naval defense capabilities. Unlike its predecessors, the KSS-III aimed to develop 3,000-ton diesel submarines with indigenous combat systems. This ambitious project promised advanced features such as automated target detection, tracking, threat assessment, and weapon control. Moreover, the submarines were to be equipped with locally built ship-to-ground cruise missiles and an innovative Air Independent Propulsion (AIP) system, enabling underwater operations for up to 50 days and enhancing stealth capabilities.

The Agency for Defense Development (ADD), Korea's sole defense research tank, took charge of the project. On February 12, 2009, ADD issued a total of five Requests for Proposals (RFPs) for the KSS-III project, covering both the CM and SONAR portions. The project's structure and ambitious goals set the stage for what would become a controversial and highly scrutinized procurement process.

## **The Teaming Arrangement and Bidding Process**

In response to the RFPs, two major players in the Korean defense electronics industry, Samsung Thales Co., Ltd. (STC) and LIG Nex1 Co., Ltd. (LIG), swiftly moved to form a collaborative arrangement. Their decision to team up was influenced by several factors, chief among them being ADD's prohibition of overseas collaboration in the RFP. This restriction, aimed at fostering domestic capabilities, effectively narrowed the field of potential bidders and encouraged local partnerships.

STC and LIG entered into two separate teaming agreements (TAs). Under the first TA, STC took the role of prime contractor for the CM portion of the project, with LIG acting as its subcontractor. This arrangement leveraged STC's substantial prior expertise in implementing key surface vessel CM projects. The second TA positioned LIG as the prime contractor for the SONAR portion, with STC taking on a subcontractor role for the development of CM-based sub-areas requiring interface with SONAR.

The companies justified this collaboration to blend their complementary strengths and resources, arguing that it was necessary given the project's complexity and the restriction on foreign partnerships. They formalized their mutual collaboration in March 2009, just weeks after the RFPs were issued.

In early April 2009, both STC and LIG submitted their respective tenders for the CM and SONAR portions of the project. When the tender process closed on April 9, a situation arose that would later draw intense scrutiny: STC emerged as the sole bidder for the CM portion, while LIG was the only bidder for the SONAR part. This unexpected outcome led ADD to initiate a rebid process for additional tenders. However, after a month-long hiatus, it became apparent that no additional bids would be forthcoming.

## **The KFTC Investigation**

The selection of STC and LIG as sole bidders for their respective portions of the project raised suspicions of potential collusion. Acting on a tip-off from another defense contractor, the Korean Fair Trade Commission (KFTC) initiated a probe to determine whether the teaming efforts of STC and LIG aligned with South Korea's fair trade laws and regulations.

The investigation was conducted under the framework of the Monopoly Regulation and Fair Trade Law (MRFTL), South Korea's primary antitrust legislation. Specifically, the KFTC focused on Article 19(1) of the MRFTL, which prohibits business entities from engaging in concerted acts that unduly curb competition in a specific trade or domain.

The KFTC's investigative process was thorough and multifaceted. It included two unannounced onsite investigations of the business premises of both STC and LIG, conducted in August 2009 and December 2010. The commission also called in relevant officers from both contractors for face-to-face questioning and provided opportunities for the companies to submit written statements outlining their positions.

## Key Findings and KFTC's Determination

The KFTC's investigation uncovered a wealth of evidence suggesting collusion between STC and LIG. Some of the key findings included internal memos from both companies that suggested prior knowledge of each other's capabilities and strategic planning for collaboration. Documents from STC revealed that the company considered LIG its chief contender in CM and planned to "defend the challenges of company B through elaborate strategic map-outs," suggesting that competition was feasible but deliberately avoided.

Perhaps most damning was the evidence of bid price inflation. An internal STC bid forecast simulation showed that in a normal competitive bid, STC's bid price would have been lower by 31.9 billion KRW. The actual bid price of 160 billion KRW (98.3% of the project budget) was deemed unfeasible without collusion. Additionally, handwritten notes from a LIG executive mentioned "pie slicing" and "strategic alliance," indicating discussions about market allocation between the companies.

On February 1, 2012, after a lengthy investigation and deliberation process, the KFTC issued its verdict. The commission found STC and LIG guilty of bid-rigging, issuing cease and desist orders and imposing substantial administrative surcharges on both companies.

In its definitive written decision, the KFTC provided a detailed rationale for its findings. It determined that the teaming arrangement between STC and LIG constituted an improper concerted act in contravention of the MRFTL, specifically violating Article 19.1.8, which prohibits agreements that unduly restrain competition. The KFTC dismissed the companies' assertion that their arrangement was a legitimate vertical consortium, arguing that evidence indicated both companies could have competed against each other, particularly in the CM portion, but chose not to.

Furthermore, the KFTC rejected the argument that the primary purpose of the collaboration was to create technological synergies and efficiencies. Instead, the commission concluded that the main aim was market allocation and price collusion. The companies' claim that the cost-plus nature of the contract would preclude unjust enrichment was also dismissed, with the KFTC maintaining that the inflated bid prices would inevitably affect the final contract prices, even in a cost-plus structure.

## Legal Challenges and Court Rulings

The KFTC's decision was not the end of the matter. The case proceeded through the court system, with initial challenges and appeals. The [Seoul High Court](#) initially ruled in favor of the companies in 2013, concluding that STC and LIG were not in a competitive relationship in the specific bidding fields. As such, the High Court determined that their agreement did not constitute an unfair collaborative act under the Fair Trade Act.

However, the [Supreme Court of South Korea](#) took a different view, overturning the lower court's decision in February, 2016. The Supreme Court's analysis delved deeper into the nature of competition in specialized markets like defense procurement. In its ruling, the court emphasized that even if the likelihood of securing a bid was low, the mere intent to participate in the bid could exert competitive pressure on the market.

The Supreme Court's decision was based on a careful examination of evidence that suggested both companies were acutely aware of each other's strategies and adjusted their bids and cooperation accordingly. The court highlighted several key pieces of evidence, including internal documents revealing knowledge about the exclusion of overseas cooperation, strategy documents suggesting examination of both competition and cooperation strategies, and continued negotiations between the companies even after the RFP was announced.

The Supreme Court's legal reasoning emphasized that both companies continued to act in ways that suggested they viewed each other as potential competitors, despite the official constraints on overseas cooperation. The court found that their internal communications and strategy documents evidenced a competitive relationship that aimed to restrict competition. This behavior, the court ruled, constituted an agreement to limit competition, falling under unfair collaborative practices as defined by the Fair Trade Act.

### **Damages Compensation Cases**

The legal proceedings extended beyond the initial antitrust rulings to include damages compensation cases. The Agency for Defense Development (ADD) filed a lawsuit against the defense contractors, alleging financial harm due to the bid-rigging. This case brought to light the complexities of assessing damages in specialized military contracts, particularly those with cost-plus-fixed-fee structures.

The Seoul High Court's recent [2023 judgement](#) in these cases demonstrated a nuanced understanding of the complexities involved. Notably, the court emphasized the importance of using appropriate methods to estimate damages in cases involving specialized military contracts. The court favored an econometric analysis, specifically a dummy variable estimation method, over more traditional approaches such as market comparison or cost-based calculations.

This preference for econometric analysis is significant. It reflects an understanding that in highly specialized fields like submarine development, where market comparisons are scarce and cost structures are unique, more sophisticated analytical tools are necessary to isolate the effects of alleged collusion. By controlling for various factors that influence bid amounts, this method allows for a more precise estimation of the impact of anti-competitive behavior.

The court's partial overturning of the [first-instance judgment](#), which had ruled in favor of the companies, awarding ADD approximately 3.1 billion KRW, represents a middle ground. It acknowledges that some level of financial harm likely occurred due to the collusion, but also recognizes the difficulties in precisely quantifying such damages in complex, long-term defense projects.

### **Implications and Broader Significance**

The KSS-III submarine project bid-rigging case holds profound implications for South Korea's defense industry and offers valuable lessons for global defense procurement practices. As the first collusion case involving a defense R&D project in South Korea's history, it sets a significant precedent for future scrutiny of teaming arrangements in defense procurement.

This case highlights the ongoing challenge of balancing the need for collaboration among a limited pool of capable contractors with the imperative of maintaining fair and competitive bidding processes. It underscores the importance of robust regulatory oversight in defense procurement, even in projects with significant national security implications.

Meanwhile, the case points to the need for clearer guidelines on acceptable teaming arrangements in defense procurement, particularly in projects where domestic capabilities are being developed. The decision may influence how defense contractors approach collaboration in future R&D projects, potentially leading to more cautious and transparent partnering arrangements.

Moreover, this ruling has broader implications for global defense procurement practices. It highlights the need for clear guidelines on acceptable forms of collaboration in defense projects, particularly in nations seeking to develop domestic capabilities while maintaining competitive markets. The decision also underscores the importance of robust regulatory oversight in defense procurement, even in projects with significant national security implications.

As nations worldwide grapple with similar challenges in their defense sectors, this South Korean case offers valuable insights. It demonstrates the complex interplay between national security interests, technological advancement, and antitrust regulations. Moving forward, policymakers and industry leaders may find it imperative to navigate this intricate landscape with care, ensuring that the pursuit of national defense capabilities does not come at the cost of market integrity and fair competition.

### **Further analysis – comparative Perspective on Teaming Arrangements**

To fully appreciate the complexities of the KSS-III case, it is valuable to consider how teaming arrangements are viewed in other jurisdictions, particularly the United States. This comparison highlights some crucial differences in regulatory approaches and underscores areas where South Korea might benefit from policy reforms.

In the United States, the Federal Acquisition Regulation (FAR) explicitly recognizes the concept of “contractor team arrangements” (CTAs). The FAR acknowledges that such arrangements can be beneficial from both government and industry perspectives, allowing companies to complement each other’s capabilities and offer the government optimal combinations of performance, cost, and delivery. This recognition is particularly relevant in complex research and development acquisitions, much like the KSS-III project.

Crucially, the U.S. system provides a clear statutory framework for teaming arrangements in government-funded programs, while still maintaining that these arrangements must not contravene antitrust laws. This balanced approach allows for collaboration where it serves the public interest, without compromising on fair competition principles.

In contrast, South Korea’s regulatory landscape lacks such explicit provisions for teaming arrangements in defense R&D procurements. While the Government Contracts Law does allow for “joint bidding” where multiple contractors can collaborate as a prospective prime contractor, it does not provide for prime-subcontractor teaming collaborations as recognized in the U.S. system. This regulatory gap is particularly noteworthy given the increasing prevalence of teaming arrangements in South Korea following market liberalization in 2009.

The concept of “co-opetition” – cooperation between traditional competitors – has gained traction in the U.S. defense industry as a means of survival in a shrinking market. This trend is equally relevant to South Korea, where the government holds monopsony power as the sole domestic buyer of defense goods and services. In such a regulated environment with high entry barriers, only a limited number of contractors are typically capable of meeting the sophisticated requirements of military R&D projects.

Given these market dynamics, teaming arrangements in South Korea’s defense sector, whether voluntary or government-mandated (as in the KSS-III project), can serve crucial functions. They allow contractors to pool resources, anticipate customer requirements more effectively, and achieve efficiencies in complex R&D projects. However, the KSS-III case demonstrates the fine line between beneficial collaboration and anti-competitive behavior in such arrangements.

This comparative analysis suggests that South Korea might benefit from developing a more nuanced regulatory framework for teaming arrangements in defense procurement. Such a framework could explicitly recognize the potential benefits of these arrangements while still maintaining strict safeguards against anti-competitive practices. This approach would align more closely with international best practices, as exemplified by the U.S. system, and could help prevent future controversies like the KSS-III case.

Moreover, this perspective underscores the need for antitrust authorities and courts to consider the unique characteristics of the defense industry when evaluating potential anti-competitive behavior. The strategic significance of defense projects, the limited pool of capable contractors, and the potential efficiency gains from collaboration all need to be weighed against the principles of fair competition.

In light of this comparative analysis, the KSS-III case can be seen not just as a landmark in South Korean antitrust law, but as a catalyst for potential regulatory reform. It highlights the need for a more sophisticated approach to competition law in the defense sector, one that balances the imperatives of national security, technological advancement, and fair market practices.

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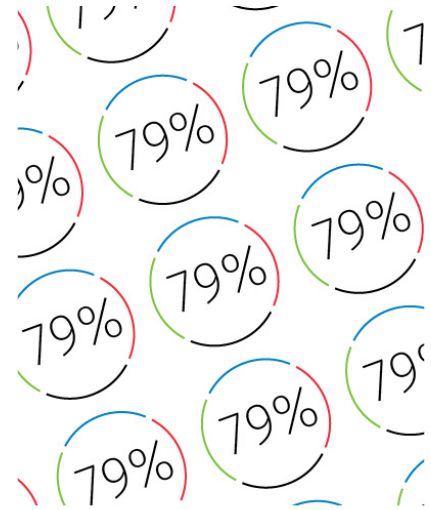
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