

## The Changing Economic and Legal Environment for East-West Investment

As your opening speaker I assume that you want me to give you an insight into what is going on in this exciting new field, what is likely to happen to it in the foreseeable future, and how an attorney who specializes in international transactions generally and in East-West trade and investments specifically, goes about planning, negotiating and structuring transactions for American corporate clients.

If you are to follow me into this strange legal world, a world which is far outside the range of the average corporate attorney, I must first make a few political, economic and even ideological allusions. The contrasts between the Eastern and Western systems are great indeed and the legal issues that arise cannot be properly understood without reference to this broader framework.

Almost five years ago I published a book, *Weapons of Peace*, in which I wrote:

In the historic contest between Western democracy and Eastern communism our most effective weapon is not our far-flung and costly military establishment but our superior capacity for economic progress. The tender sword that will open the East is economic and industrial cooperation and the human freedoms that go with it.

I submit that at least two parts of this thesis are now proven. As to our far-flung and costly military establishment, today's tragic events in Indochina demonstrate that this weapon is not the only one we must rely on if we are to face the future with confidence. As to economic and industrial cooperation with the East, it has developed over the last five years to a point which is almost astounding.

On the subject of human freedom, while there is increasing circulation of ideas and of people between East and West, the progress has so far been far too limited. All in all, the balance seems, however, positive and promising.

The world economy has become increasingly transnational in the last two decades. In the last five years it has acquired a new dimension. It has become

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trans-ideological as well. Somehow business people have managed more effectively than armies, churches, or diplomats to cross national and ideological borders. I believe this is a welcome trend. It is a trend toward cooperation, toward stability, and even toward peace.

The cold war is behind us, although the dangers are still there, and I would not want to minimize them. Americans are beginning again, I believe, to look upon themselves more as Yankee traders than as Yankee soldiers. Our military preoccupations in the last quarter century, while essential, were going against the national grain. I think we are more ourselves when, in addition to being vigilant about our security, we wield those weapons of peace that I define as economics, commerce, technology, and all the great achievements that have made this country so productive and envied for almost 200 years.

For the indefinite future we will have in the world two different types of societies, two different types of economies. One is based on private enterprise; the other is based on state enterprise. It is fairly clear that one will not destroy the other with thermonuclear bombs. It is equally clear that neither will voluntarily dismantle its own social and economic institutions.

If you accept this premise, then you must accept a conclusion which I think is very important for our profession. As practicing lawyers interested in this opening segment of the world economy we must help develop new legal techniques that would enable expanded business intercourse across ideological barriers.

Let me be more specific. What is new from an economic and legal point of view in this area?

The first thing that is new is that the United States, after many years of absence, has returned to most of the Communist markets of the world. This absence has not been a healthy one. It was abnormal for an economy like ours, which has a gross national product much larger than that of the nine Common Market countries put together, to have only one-tenth of the Common Market's trade with the East.

The Europeans and the Japanese have looked upon the Eastern markets for many years as their private hunting preserve. That has now changed. American industry is now negotiating transactions. It is signing contracts. It is importing and exporting. It is constructing plants. It is also beginning to invest.

This change has provoked waves in Europe. Many Europeans say to me in Paris and London: "You Americans are creating with the Russians a new kind of Yalta. You are trying to exclude us from these markets. You are doing to us economically today that which you did 30 years ago politically." I believe this is nonsense. All that is happening is a normalization of a highly abnormal situation.

The other thing that is new is that America and Russia have somehow developed a liking toward each other in the economic field. To me, again, this is completely logical. If we set aside for a moment the political and ideological differences which exist, and will continue for a long time, and if we look at the underlying economic realities, we find a strange, paradoxical affinity between the United States and the Soviet Union.

Both are continent-size countries. Both have populations exceeding 200 million people, a variety of climates, vast seacoasts and rivers and enormous natural resources.

The challenge which the Soviet Union faces today, and I believe the more reasonable and creative leaders there are fully aware of this challenge, is how to establish an efficient system of mass production, and mass distribution to feed and clothe 250 million souls living in a vast continental expanse.

Where has this job been done? It has been done in the United States, a long time ago. I believe, therefore, that America's historic example is today highly relevant to Russia's pressing needs. This is why there is an apparent love story between the Soviet and American industrial communities. And this is why there are so many contracts negotiated by large corporations.

It is a question of size. The two countries are of the same scale. They like to think big because of the realities I have just mentioned. A Soviet Minister has recently put it this way: "Our projects are enormous. Almost every one of them is worth a billion dollars. When I deal with European companies they do not have sufficient industrial, credit and management capacity. When I sign them up for a large project, I have five or six contracts, which gives me five or six headaches. When I deal with a large American company, I have only one headache."

The next thing that is new is that economic relations are not only expanding quantitatively; they are also expanding qualitatively. It is no longer enough to speak of Soviet-American trade, or East-West trade, in terms of physical commodities that change hands in export and import. This can be at best a limited thing, because there is an inevitable ceiling that hangs over this type of trade, owing to hard currency shortages and means of payment on the other side.

The nature of transactions is now evolving in a different direction. We see more and more exchanges of technology and patent and know-how licenses. We see the beginning of investments. Many transactions that I would characterize as investments have been fully negotiated, and even put into operation. A number of them have proven profitable to both parties.

In Eastern Europe, the development of investments as a growing supplement to trade is clearly apparent. I recall in 1967 and 1968 my advice to a large corporation that was planning to build luxury hotels in Eastern Europe when such a transaction seemed at first almost inconceivable because of the political

and ideological climate of the time. Imagine, a Western capitalist corporation wanting to move into a Communist economy, to make an investment in a real estate-related transaction, and to come out with a profit. But this is exactly what was done. Those of you who have been to Budapest lately will see that a magnificent modern hotel now stands on the bank of the Danube. A similar hotel stands in the center of Bucharest. Today, these types of transactions are specifically permitted by law. In 1971 the Rumanians passed a law which allows Western equity investment in Rumania with local state companies, and a number of such transactions have been closed. This followed an earlier Yugoslavian example.

In 1972 Hungary passed a similar law, and Bulgaria and Poland are considering comparable legislation. But even while such legislation remains in the planning stage, transactions of this type are being negotiated on an ad hoc basis. By now they run into the dozens.

So far as the Soviet Union itself is concerned, such legislation does not exist and, in my opinion, will not exist for a long time to come for the simple reason that the Soviet Union considers itself the fountainhead of Communist ideology. From the standpoint of Marxist doctrine, a law which allows capitalists to have ownership in Communist means of production is not an easy pill to swallow, regardless of economic need.

Nonetheless, through various kinds of pragmatic devices, transactions of this type are being satisfactorily shaped. A considerable amount of legal ingenuity has had to go into making them possible at a time when they are precluded by the prevailing philosophy and legal system. Here is an area I would particularly like to stress as a challenge to the legal profession. The need to be creative, the need to abandon old terminology and old habits, the need to open up our minds and say to ourselves that our clients are entering a completely different environment and that we must develop a new capability to assist them. For they are not going from the United States to France, or to England; they are going into a state-operated, state-owned economy where there is no competition, where the government is the manufacturer, the banker, the seller, the buyer, the insurer, the shipper, even the adjudicator, in a way.

In such an environment you cannot go to work with the traditional concepts of our own legal system, and our own principles of commercial law, practice and customs.

For example, take the mammoth Occidental Petroleum deal with the Russians, a transaction of close to \$10 billion, if all goes well over a period of 20 years. Essentially, this deal requires the American firm to help build in Russia a large number of plants to produce ammonia out of natural gas, of which there is great abundance in Siberia, together with ports, pipelines, tankers, and infrastructure, and then to buy that ammonia for the world market where it is in

short supply. In exchange, the Soviet Union has committed itself to purchase fertilizers derived from phosphates mined in the Gulf of Florida. What was really needed was to establish or expand an active industry in the Soviet Union.

Call it what you will, this is an investment. But it could not be structured as an investment and, therefore, instead of dividends, instead of profit participations, a certain price formula was invented, which would take me hours to describe, even if I were professionally free to do so. In essence by agreeing on a price for the purchase and sale of product, you can translate an ideologically inconceivable distribution of dividends into an ideologically palatable entitlement to adequate profits.

Similarly, in 1968 the Japanese negotiated an enormous deal to develop the Siberian timber industry. More than a dozen Japanese corporations and banks have signed contracts with the Russians to bring in equipment, engineers and know-how, to cut down forests and to ship the product over the long term of various parts of the world. There, again, it was impossible to form a jointly owned corporation, to have a balanced Board of Directors, or to reproduce the kind of model to which our clients are accustomed when they do business in Western Europe or in any other liberal or reasonably liberal economy. But by using a price formula and other pragmatic devices, both sides were able to accomplish their objectives without running afoul of ideology and of the law.

With this in mind, let me throw out a few hypotheticals to give you a feeling for what might happen in the years to come if investments in the East were really to take off and to become a significant factor in the world economy, as I fully anticipate.

I have already said that ownership in a Communist economy is in principle impossible, because it is constitutionally provided that no private parties can own the means of industrial production. This clearly pertains to private capitalists from abroad. Therefore, our habits of mind, or the habits of mind of our clients, who want to own and control everything, must be adjusted if business is to be done in this area. Acceptable, legitimate ways must be invented to overcome seemingly insurmountable prohibitions and, generally, a complex maze of theoretical and practical obstacles.

In the alien environment of East-West investments the notion of ownership is outmoded. I would even go so far as to say that it is unnecessary. While you cannot build a plant in the Soviet Union and hold title to it, I am wondering, however, what is to stop you in the years to come from building the plant, transferring it to the Soviet state, and taking a leaseback for say 20 years. Now you have not offended the local system, you have some form of control over the plant and you may not really need any more than that. I defy anyone to prove to me that Marx or Lenin said anything against leasebacks.

The same, let me repeat, is true with dividends. Except under the new East

European legislation I have mentioned, dividends are impossible. But you can accomplish something similar, maybe even better, with royalties, with engineering fees, with interest charges, and various other types of compensation.

American companies like to control everything wherever they establish or acquire a business, and in Western Europe we have often been able to negotiate for them in 51 percent, a 99 percent or even a 100 percent voting position. In the East this is of course, out of the question. Now, I don't want to underestimate the importance of control. Many firms operate with high technology and require very sophisticated quality control before they will allow their trade name to go on a product whether it is to be sold in the Soviet Union or anywhere else in the world.

When the Ford Motor Company withdrew from the Kama River truck plant project, almost five years ago, the main negotiator, for a while, became Daimler-Benz. In the end they pulled out too, for a number of reasons. One of these reasons was that they were afraid lest, with Mercedes-Benz engines in them, those trucks were seen in Russia and in some underdeveloped countries standing idle on the roads or being repaired in public view. Mercedes-Benz was afraid for its reputation, unless it could obtain adequate production controls. This position is understandable. The Eastern side is beginning to understand that in the ultimate analysis adequate quality control provisions serve its interest as well.

I submit to you that something in the nature of control could, perhaps, be accomplished, not by appointing Americans to a Communist Board of Directors—that is something you might as well forget—but by writing a careful management contract and by providing for some kind of technical management committee or technical advisory committee, a provision which is innocuous in concept and terminology, but which grants the Western party enough protection to accomplish what it really needs for its own good and the good of the joint venture.

The performance record of Eastern trading and investment partners is a very favorable one in Communist countries. It is now established that the level of contractual compliance is first rate. Communist banks have an excellent reputation for the way they repay loans and pay interest, and Communist enterprises usually fulfill their obligations to the letter, once they are written down in an unambiguous way: In this connection, I might add that the Communist mentality in drafting contracts is very much like the American mentality. The Russians, like American and English "common lawyers," but unlike Western European "civil lawyers," prefer to cover all foreseeable problems in their contracts. The reason is that a Soviet trade official is really a bureaucrat. He doesn't like to take risks. He has very little to gain and a great deal to lose if the

chance he takes misfires. He therefore looks for safety in carefully formulated, precise agreements.

Once there is a written agreement you can rely on it. From the standpoint of honesty and performance we have little or nothing to complain about, little or nothing to worry about, as long as the drafting has been done by a careful, experienced hand.

There are other things that make the Communist countries attractive places for investment. They have stable, growing economies. They are politically safe, strange as this may sound. If you make a large investment, no one is going to nationalize you. The entire economy has already been nationalized long ago; you have nowhere to go but up.

There are other paradoxes that lawyers run into in dealing with these countries. Let me provide a few additional examples.

How many United States companies who are about to sign a licensing agreement or a sale of engineering say, "We must have a confidentiality provision. We don't want our industrial know-how passed on by the buyer to any third party." This is second nature with our clients and their general counsel. You should see their expressions when we say to them: "You know, in the Soviet Union there is a law which says no inventor, no licensee, no plant manager has a right to any secrecy. On the contrary, if he discovers something new, if he develops a more effective industrial process, he has a positive duty to share that process with every other production unit in the country. There is of course no competition, and because of that, know-how has to be spread about. Efficient production in one state-owned plant is just as important to the society as the efficient production in another state-owned plan." How do you reconcile these two contradictory approaches to confidentiality? That is a question you have to face in almost every contract.

Secondly, consider the concept of *force majeure*. If a Communist supplier who has signed a contract with you suddenly sends you a cable: "Sorry, I cannot deliver because our Ministry of Foreign Trade canceled the export license," or "Our government has suspended the project because the priorities in the national economic plan have changed," this is allegedly a *force majeure*. And I can cite dozens of decisions of American, English, French or Italian courts which say that when the sovereign makes it impossible to perform a transaction, the axe falls where it falls and there is no liability in damages or anything else. Now, in doing business with an Eastern economy, such a solution is unacceptable to a Western company because what is to stop the president of the Communist enterprise with which you have signed from calling up the Minister who appointed him and asking the Minister to get him out of a contract by canceling his export license or passing some other disabling decree? The relationship is so close among those who make business decisions and those who make government

decisions that your Communist partner can, theoretically at least, create his own *force majeure*. Several large arbitrations are being conducted in Paris and London at the present time on this very situation.

Next, take pricing. It is impossible to know how a Communist economy determines the prices at which it wishes to buy or sell. As a matter of fact, in selling, state corporations are unable to calculate costs of production. Their accounting principles make this virtually impossible, although some of the smaller Eastern European countries are paying new attention to this problem. Generally, they look at world prices and then they say to themselves: "We have something to sell, the world price is so much; therefore, our price will be so much minus X." X is normally the small fraction that is needed to make it possible to dispose of the amount of products that must be disposed of under the official export plan. In other words, they establish their export prices by reference to prevailing prices in the capitalist markets of the world. Investment decisions in relation to the world market are also influenced by this mentality and the Western partner in such investments could not hope to impose his own criteria and the ground rules which his corporate auditors have prescribed.

I would like to end by saying this: at the firm to firm level, the process of East-West business cooperation that has been started recently has been started well. I have been observing the difficulties and distortions prevalent in this field for almost 20 years. Today I often have to pinch myself to believe that what is happening is really happening. The most important thing now is no longer whether we should do business with the East, but how to do it so that our economy and our clients can reap from it proper advantage. We must concern ourselves not only with the volume but also with the nature of transactions, and help move them into new directions, particularly from trade to investment.

What I foresee one day is a world economy that is not only integrated on a transnational basis but also on a transideological basis, where communist and capitalist companies not only deal with one another, but also jointly in the international marketplace through what I call "transideological" corporations. You can have a Communist state enterprise and a capitalist private enterprise together forming a company either to produce or to distribute worldwide. In fact, a number of such companies already exist, with the equity divided on a 50/50 basis, with the Board of Directors equally balanced, even to a point where the alternating chairman doesn't have a casting vote and the management is jointly selected. These companies have as their primary objective to produce and to sell efficiently, in short, to make a profit. That kind of cooperation begins to stagger the imagination. Through such cooperation the two formerly hostile sides are able to develop an even greater vested interest in stability for the simple reason that they want their common enterprises to continue and to be prosperous. Multiply such ventures ten thousand times, and you have a web of integrated



relationships with a lot of money and resources invested on both sides, and a lot of energy, effort and careers devoted to its preservation and perpetuation.

I hope that this pattern between East and West will spread to the less-developed countries. One might wonder what would happen in a country like India with its famine prone country of 500 million inhabitants if both sides employed such transideological corporations? The Aswan Dam in Egypt would probably have been a better dam if Russia had built it in cooperation rather than in diplomatic competition with the United States. Whatever the third world location, who could compete with a combination of this type, the Western country supplying the technology, the management, the credits, and the Eastern side supplying the raw materials, the highly skilled labor, which is still modestly paid and never on strike? Imagine a joint venture of that kind, bidding for a sugar refinery in Lebanon, a desalinization plant in Isreal, or a steel mill in Brazil!

There is also an entire area where the two sides, East and West, face the same problems and have basically similar interest. For example, how do you contain pollution in the atmosphere and the oceans on a global scale, how do you decide on the development of new sources of energy at a time when various countries are putting into operation different types of atomic reactors with risks and dangers that no one has fully evaluated? How do you cope with growing shortages in the world food and fertilizer supply? Decision-makers on both sides are now aware of the need to pool the experience and know-how that exists in the United States and in the Soviet Union for these purposes. All of these are fields where investments from the West in the East, from the East in the West and jointly in other parts of the world, make a lot of political and economic sense. The discernible pattern today suggests that with time such investments will become a normal part of the international scene.

International lawyers will have to face up to the urgent and important question of how best to advise clients in this new and rapidly changing economic and legal environment. That is the first big challenge.

The second challenge, to both lawyers and policy makers, is how to develop an appropriate institutional framework of laws and regulations that would encourage development of trade and investments among a free enterprise system such as ours and a state enterprise system such as theirs.

**QUESTION:** In drafting these contracts, you have a language problem. How do you solve it?

**MR. PISAR:** It depends on which country you are dealing with. Nothing is better than a knowledge of the local language. If you go to Romania, you can do almost anything in French. Every Romanian seems to speak French. The Hungarians speak German, for obvious historic reasons. The same is true in Czechoslovakia. The Poles speak Russian, but prefer to speak French or English. In the Soviet Union a knowledge of Russian is certainly important,

although some business can easily be transacted in German or English.

If your client goes to any of these countries he needs an interpreter unless, of course, his East-West counsel speaks all of the above languages. When necessary, the Eastern side will provide an interpreter, but you may prefer to take along interpreters of your own and many companies do.

The contract itself is normally, at least in the Soviet Union, in two languages, Russian and English, in the case of a United States company, and the two texts are equally authentic. What would happen if a dispute arose and the two texts were in parts contradictory? Which one would prevail? We don't really know how an arbitrator or judge would resolve this conundrum. In the small East European countries many contracts can be negotiated and signed in English, French or German alone.

**QUESTION:** You mentioned the possibility of a sale-leaseback in an Eastern country as a means of gaining effective use of productive assets while skirting the issue of actual ownership. What are your views on the possibility of using a lease of equipment or a plant as an effective financing mechanism outside the plan, where you can structure possible tax advantages for a Western company, a good cash flow for the Eastern partner, but retain ownership effectively of assets located in an Eastern country?

**MR. PISAR:** That might even be easier than a leaseback on a plant. Several such transactions have been negotiated. There are some issues that you must think about. If it is going to be a lease of equipment, you are going to be the owner of that equipment. Now, suppose the rent isn't being paid, and you have to repossess. You would normally require, under such a lease, the guarantee of the state foreign trade bank of the country where you are locating the equipment, and the guarantee of such a bank is very good.

**QUESTION:** Would they guarantee lease payments as well?

**MR. PISAR:** In some of the East European countries they would. Therefore, the question arises, if they do that, they might as well undertake to pay for the equipment in installments and in that case the entire lease concept begins to resemble a foolproof loan.

**QUESTION:** What would be the ordinary length of time to complete a transaction, not a Kama River plant-type thing?

**FROM THE FLOOR:** One transaction, from start to finish in the Soviet Union, which had to go to the Council of Ministers for approval, was completed in less than a year, but there was some precedent on what the negotiation was all about. We have done the same thing in Poland in less than a year.

**MR. PISAR:** I would say that is an average time. I have known transactions that have been going on for years and are still not closed. On the other hand, when the Soviet Union has a shortfall in the economic plan, some plant didn't perform the way it was expected to, or the product that came out was defective,

and the rest of the economic plan all along the line is waiting because the product is urgently needed, there is then a high priority. When that happens, you can move in and in a matter of weeks negotiate and sign a very complex transaction.

**QUESTION:** Would you tell us what you foresee in the development of the attitude of the United States Government toward export licenses for high technology?

**MR. PISAR:** The attitude has changed drastically, not only the attitude of those who administer the export control legislation, but the legislation itself was liberalized in 1972. Today there are two things to consider. First, the Department of Commerce which, for the most part, has jurisdiction to say what is strategic and cannot be exported. It has lately become quite generous in its interpretations. The second thing is that the American export control criteria that used to be much more severe than the strategic criteria of the Western alliance as a whole (plus Japan) are now much more similar.

