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Industrial Contracts with the East

It has been a rather brief period of time, not much longer than a decade, since industrial cooperation emerged as a promising new vehicle of East-West business. During this period, the evolution has been rapid. European and Japanese companies, including some subsidiaries and licensees of American firms, were first to realize the potential. However, in more recent years, in an improving political climate, a growing number of American companies have become directly interested in the opportunities in the Eastern markets, and in the possibilities for obtaining a lasting foothold there through long-term investment of resources.

There is every reason to believe that this process will continue to expand, since it responds to important needs on both sides. To Western firms it promises, at a time when traditional markets are saturated, substantial new export outlets for their capital goods and equipment. To Eastern governments, it promises an infusion of applied technical sophistication badly needed to modernize their economies.

Even the Soviet renunciation of the Trade Agreement in January 1975 has not seemed to dampen their desire to pursue industrial projects with American firms. Indeed, in the intervening three months since that renunciation, I have been to Moscow three times and have seen three agreements signed with our U.S. clients.

There is a challenging role to be played by the lawyer advising his client or his company in this highly specialized field, for to advise how to proceed, how to negotiate, how to structure agreements, he must understand not only the legal regime, but also something of the fundamentally different economic, social and political environment of the East, with its own peculiar motivations, objectives and constraints.

Industrial cooperation, as that term is used in East-West practice, encompasses a great variety of transactions, ranging from simple license

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agreements to complex investments in joint production. It may entail the transfer or exchange of technical knowledge and experience either in the form of patents or know-how, the licensing of trademarks, the supply of turnkey plants or complete processes, the exchange of components, semi-finished goods, and even finished products manufactured under license, technical assistance, services and training programs in connection with industrial activities, joint marketing arrangements in each other's territories, as well as in third countries, occasionally established through jointly owned stock companies set up in the West, joint research and development activities, and in the case of Yugoslavia, Romania and Hungary, joint venture companies based on equity sharing, a fascinating subject in itself which will be dealt with in a separate session of this Institute.

The essential characteristics of all of these arrangements are, first, their long-term character, usually extending over a number of years; and second, the inclusion of reciprocal responsibilities in production, exchange of technology, marketing, or the like, which go beyond the straight sale of goods and services.

A common feature of most cooperation projects is the Western supplier's undertaking to counterpurchase some of the products manufactured with its assistance or under its license with a view on the one hand to defray the hard currency cost to the Eastern party of the production contract, and on the other hand to provide the Western party with a presumably economic and reliable source of supplies for its own use, resale, or other disposal.

It might be well to inject here that East-West industrial cooperation is gradually becoming a two-way street in that we are now beginning to see a reverse flow of technology. Inventions developed in the East can sometimes be exploited effectively in the West. There was recently an announcement in the press of a firm in Texas that had bought a Soviet process for several million dollars which they expect to develop and use in the American market. As long as seven or eight years ago the Czechs successfully licensed a U.S. firm with know-how for the production of soft contact lenses, which the licensee has now successfully marketed in many Western countries. There is a growing number of such cases.

That being said, in the context of the present Institute, my remarks are aimed primarily at transactions in which the Western party will be the supplier of plant equipment or technology, rather than the purchaser.

There are many basic questions to be answered before one can hope to arrive successfully at a cooperation contract in the world of the foreign trade monopoly. Your client must know where and how to spark interest in a proposed project, the role of the Eastern government in the negotiations, the authority and responsibility of the bureaucrat sitting opposite you at the bargaining table, and the ways in which the Eastern objectives are similar to or different from those typical in the West.

The answers to these and other similarly fundamental questions are not the

same for all Eastern countries. There have been significant economic reforms taking place throughout the East, so that today important divergences exist in the ways and means by which these countries do business with the West.

There has, however, been a common trend toward direct participation by production enterprises in negotiations with foreign firms. It has gone so far in a few cases that the end-user enterprise not only attends the negotiations but may even replace the foreign trade corporation as the contract principal. For example, in Hungary since the 1968-69 economic reform, well over a hundred industrial enterprises have been authorized to engage directly in import and export.

To the extent that this avenue to the end-user is open, it greatly facilitates the negotiating process by enabling the real partners to speak directly to one another early in the game, both on technical and commercial questions. While the Soviet Union remains the bastion of the foreign trade monopoly system, even there we are beginning to see signs pointing toward gradual decentralization, with All-Union Industrial Associations assuming new responsibilities in production for export. However, to a large extent the classic Soviet economic model is still generally applicable throughout the East and, of course, in the U.S.S.R. itself.

Under this model, all commercial activity turns around the national economic plan devised by a central planning agency and implemented by state-owned enterprises. These enterprises act pursuant to directives which they receive from their respective ministries. The plan has the force of law and regulates the allocation of resources, production objectives, pricing, and so forth.

The foreign trade aspect of the plan falls under the jurisdiction of the Ministry of Foreign Trade, which enjoys the monopoly over all commercial activities with foreign firms. The Ministry oversees a number of foreign trade corporations which conduct the actual day-to-day negotiation and conclusion of specific contracts. Each of these corporations is entrusted with a particular segment of the monopoly, consisting either of a category of goods, technology or services, or geographical region, and in its area conducts the total import-export activity of the country.

Thus, in most cases it will be with the specialized foreign trade corporation that a Western firm wishing to establish local production will ultimately have to negotiate and contract. However, while the foreign trade corporation may be the legal partner, the real party in interest in an industrial cooperation venture will invariably be the domestic enterprise of an industrial ministry. It is this enterprise that will be called upon to make the internal investment and commit the effort and resources on the Eastern side in connection with the startup of new production. It is, therefore, at the internal ministerial level that the company must spark interest and cooperation, and at this operative level it should seek to define the technical aspects of a specific project.

Access to the client ministry remains a more complicated matter in the Soviet Union than it now is in many of the Eastern European countries, and warrants some further comment. A possibility to gain exposure, if not access, lies in participation in industrial expositions organized by the U.S.S.R. Chamber of Commerce and Industry or by means of privately organized seminars, symposia, and other promotional activities. However, a particularly effective access—utilized especially by the larger Western firms—is via a protocol agreement negotiated directly with the Soviet State Committee for Science and Technology. As of April 1975, more than 170 such agreements have been concluded by Western firms, including 37 by leading American corporations such as Occidental Petroleum, General Electric, Hewlett-Packard, Control Data, FMC, Kaiser Steel, Coca Cola, Allis-Chalmers and others.

The State Committee is a direct arm of the Council of Ministers of the U.S.S.R. and consequently is a governmental body of ministerial status. Its function is to supervise and coordinate all research and development activities in the Soviet Union, including the organization of industrial and technological cooperation with foreign countries.

A framework agreement with this body can serve several distinct and important purposes. First, it singles out the Western company to Soviet business as a most favored partner. Secondly, it constitutes a direct governmental pledge to pursue a long-term relationship with that company, valid for repeated transactions over many years.

Finally, and of great practical significance, it makes available State Committee auspices to facilitate contacts and negotiations with the relevant ministries and organizations.

This being said, it should be understood that such an agreement is a protocol rather than a contract. To implement specific deals, it will still be necessary first to structure a mutually acceptable technical agreement with the relevant ministry; and second, to negotiate and conclude implementing contracts with the relevant foreign trade corporations.

What, then, does the framework agreement actually say? Generally, it defines in broad terms the scope of cooperation which the parties agree to explore together and calls for the establishment of groups of experts who will meet on a regular basis to consider the feasibility of specific proposals and to elaborate concrete programs and projects for joint implementation. In essence, the framework agreement not only facilitates technical contacts; it institutionalizes them.

In the more complex East-West projects, the technical negotiation phase can be a long and slow process, as the parties become acquainted with each other's capabilities and try to work out the parameters of a mutually acceptable project. Where the project requires the participation of more than one ministry due to the range of technology or equipment involved, the bureaucracy and decision making can aggravate the time factor considerably.

There are a number of Eastern objectives in structuring technical projects which seem to recur with few exceptions as an almost standard philosophy. To the extent that the Western party can anticipate these objectives and can render them compatible with his own, it may be possible to significantly shorten the technical stage of negotiations.

For example, it is a common objective of Eastern enterprises to seek to maximize the use of domestically produced equipment and materials in connection with cooperation projects in order to reduce the hard currency expense of the transaction. It is often advisable, therefore, for Western parties to define separately those items of standard equipment and possibly special equipment which may be locally sourceable.

Even in the so-called turnkey projects, the Eastern side should be expected to supply locally available equipment, as well as the building itself, necessary utilities, and, of course, local labor. Naturally, items which are critical to the technological processes involved or which reflect the proprietary know-how of the Western party must remain its responsibility.

A second common Eastern objective is to focus complete responsibility for delivery of all foreign plant, equipment and technology upon a single Western party, who then functions as a prime contractor, assembling the necessary equipment, material and licenses to supply a total package.

From the Eastern standpoint, it is cumbersome and often unfeasible to attempt to negotiate multiple contracts for the implementation of a single project. Indeed, where they have tried to do this, as the Soviets have done in the mammoth Kama River project, for example, there have been dramatic problems of bad coordination. Whether a Western company can afford to assume this kind of responsibility is, of course, another question. Where a significant part of the plant project involves equipment and technology belonging to third parties, such an approach may expose a company to substantial risk, not to mention the enormous burden of negotiating a great number of subcontracts and licenses with its own suppliers. However, where such an approach is manageable, it may well be desirable to contemplate it from the outset in preparing a cooperation proposal. Not only may it speed up the technical negotiation process; it may also increase the chances of overall project success since there will be greater certainty of appropriate supply within the required time frame.

Still another Eastern objective in industrial cooperation projects is the possibility of selling back to the Western partner some of the product manufactured under license. From a commercial standpoint, the purpose here, of course, is to help offset the hard currency cost of plant and technology. However, from a technical standpoint, the willingness of a Western party to commit to such counterpurchase is also an assurance that the technology which

the Eastern party is receiving is indeed modern and competitive on world markets.

While there are obvious difficulties in predicting long-term purchase requirements, it is desirable for the Western firm to try to define an order of magnitude for counterpurchase potential if any exists at an early stage, since the level of contemplated purchasing can substantially affect the size of a given plant and the quantities, types and values of equipment to be delivered. Where this issue has been deferred too long, I have seen it result in an expensive duplication of effort in re-scoping the project to allow for additional capacity.

One more typical objective which might be added to this list of illustrations is the Eastern desire to seek maximum if not total operational independence in the licensed activities as soon as possible. To this end, early targets are usually requested for equipment deliveries, transfers of know-how, plant erection and installation under Western supervision and phasing in of local supplies and materials.

When this work is completed, the Eastern party would like to be able to operate with little or no continuing Western support. In many cases, this objective may not, as a practical matter, be obtainable given the level of existing local skills in the particular industry and taking into account the additional time which experience shows must be factored into any work program to be performed in the East as compared the West.

It also may not be compatible with the interests of the Western party. For example, where there is a long-term commitment to counterpurchase a licensed product, or where a health product or a trademark may be involved, the Western party may need to be able to control quality and implement improvements during the production process on a continuing basis extending well beyond plant startup.

In some of the East European countries, continuing Western assistance for this and similar purposes can occasionally be agreed upon in one form or another. In the Soviet Union, on the other hand, there remains a strong aversion to such open-ended arrangements. This being said, there is reason to believe that the concept of ongoing on-site participation is gaining ground and may soon be more readily obtainable throughout the East, at least where a clear need for it can be shown.

The serious commercial negotiations at the Ministry of Foreign Trade normally begin after basic agreement has been reached on the scope of the technical project. The commencement of these negotiations can be something akin to taking a cold shower. After having spent months developing a rapport and a mutual understanding with the end-user enterprise, a company is confronted with a new partner who may have only a limited familiarity with the transaction, and whose principal motivation appears to be to buy as much as possible for as little as possible.

Here, again, good preparation can save time and avoid pitfalls. Over many years, as buyers and sellers of goods and equipment, the foreign trade corporations in the various Eastern countries have developed rather standardized approaches in their dealings with Western firms, which are reflected both in their contract forms and in their negotiating tactics.

As a result, it is often possible to anticipate the issues which are likely to arise and to develop in advance the most suitable strategy. Conceptually, the foreign trade corporations tend to view industrial projects as involving principally sales of equipment, with ancillary supply of know-how and assistance.

In my own experience, this conception is often diametrically opposed to that of Western parties, who frequently view the very same projects as a supply of know-how and assistance, with the equipment sales being ancillary.

The difference is more than semantic. It can have considerable impact on the definition of the scope of the contract, the obligations of the parties, the performance guarantees, the payment terms, and other key provisions.

In order to cope with this problem, and at the same time avoid a protracted and frustrating battle over contract forms, a pragmatic solution which I have personally found to be effective on many occasions, is to structure the client's proposal in a form familiar to the Eastern party, but with a content designed to protect the client's interests and reflect his objectives. If it is properly done, this contract proposal may serve as the text for final discussion. At the very least, it will enable you quickly and effectively to integrate your positions with those of the Eastern side in the event that it counter-proposes its own text.

This can be very important under the time and logistical pressures of the final round of negotiations.

Much has been published in recent years on the subject of Eastern standard contracts, and in particular their emphasis on specific and timely performance of obligations, with strict guarantees and stiff penalties for late delivery, their distinctive view of *force majeure* as concerns strikes on the one hand and Acts of State on the other, their special approaches to dispute settlement and choice of law, and the like.

While this is essential material in preparing you for a commercial negotiation, it should not leave you with the impression that Eastern form contracts are sacrosanct and non-negotiable; on the contrary, today nearly any provision, even in the Soviet-form contracts, is open to negotiation and can be modified within limits which are being stretched daily.

Moreover, while the formal contract will typically relate to the supply of equipment, other matters can be creatively elaborated in specially adapted contract appendices. The possibilities for innovation are particularly great in these appendices, since by necessity they are unique in each transaction. Here, for example, it is possible to develop the notion of a project partnership, with common goals and separately defined responsibilities, or a technical assistance

program so broad that it constitutes a *de facto* management contract valid for a term of years.

This being said, there are two obvious prerequisites for negotiating the most favorable terms and conditions. First, that you enjoy a good bargaining position; that is to say, that the Eastern side wants the deal, has the budget, and would prefer your client over another firm. Second, that you have the ability to distinguish between real issues critical to the Eastern party and those raised purely for tactical purposes, and the know-how to deal with these issues as they arise.

Just as there is flexibility in negotiating contract forms and appendices, there is also flexibility in negotiating the all-important price and payment terms. It has been customary practice in the past for Eastern negotiators to pressure Western companies early in their discussions for firm prices and detailed price breakdowns for plant and equipment.

Many Western firms accede to these demands, in my opinion, prematurely, only to discover later on that the scope of the project has grown or that the negotiations have lasted longer than expected, with inflationary strains on their pricing, or that new risk and cost factors have been injected into the original terms and conditions.

These companies learn the hard way that it is difficult to negotiate a price increase even where it is clearly warranted. The foreign trade corporations justify their very existence by their ability to obtain price discounts. It takes considerable convincing to increase the price, once quoted.

Firms can and should sidestep such demands for specific price information, or defer them until late in the day when a final contract is in view. Not only will this enable the Western party to define a price which reflects the agreed scope and conditions of the contract and current costs; it also will limit the Eastern party's ability to shop for competitive prices on individual items of equipment and will, thus, substantially simplify the ultimate price negotiations.

The question of pricing itself is, of course, a highly judgmental one which will vary from case to case. There is, however, a common dilemma. Where an initial price is stated too high there may be no negotiation at all. Where it is stated too low, you may have insufficient flexibility to make the final concessions which are typically demanded by Eastern negotiators.

It is becoming increasingly common for the foreign trade corporations to accept escalation clauses in their agreements for supply of plant and equipment with Western firms. To the extent that this is available, it may provide at least a partial escape from this dilemma.

Obtaining compensation for patents and know-how, either under separate license agreement or in conjunction with sales of plant, is a subject unto itself. Hard currency compensation is obtainable and can take the form of a lump-sum payment or fixed installments, or even periodic royalties based on production.

The difficulty with fees based on production or other performance criteria is that of monitoring or controlling the activities of the licensee, since access to the local plant and market is still relatively restricted, especially in the case of the Soviet Union.

One possible approach which enables the Western licensor to enjoy a share of the market without excessive risk is a production royalty with guaranteed annual minimums based on the plant production program. If the plan under which the project is taking place is increased, the Western party will share in the additional benefits. If the plan is decreased, he will nonetheless receive the agreed upon minimum return for his invested technology.

A particularly hard point to negotiate in industrial cooperation licenses is the value of know-how. Where technology is in the form of locally registered patents, it is considered as tangible property with an ascertainable value. However, unpatented proprietary know-how which, by definition, remains intangible and undisclosed until after contract signature, is considered to be a "pig in a poke," or, as the Russians call it, a "cat in the bag."

While the Western company can justify its know-how fees by demonstrating its investment in research and development as well as the successful results its technology has produced on other markets, in the final analysis the willingness of the Eastern party to pay for the real worth of know-how will depend on the uniqueness of its availability and its importance to their economy.

There are two more fundamental points which I would stress to Western firms when pricing know-how. First, regardless of whether a license is characterized as exclusive or non-exclusive, as a practical matter in almost every case they should understand that they will probably not be able to license the same technology twice in the same Eastern country, since there is only one potential partner under the usual foreign trade monopoly system. Yugoslavia is an exception to this.

Secondly, they should understand that as a general rule Eastern licensees consider that they are purchasing know-how and not merely obtaining a right to use. In effect, they view periodic royalties as equivalent to installment payments on the purchase price. Consequently, for financial as well as other reasons, it is usually in the interest of the Western party to seek a long duration to a license contract, and if it is likely that the know-how will not be obsolete at the end of the term, to provide for continued confidentiality after contract expiration.

A basic price element in most industrial cooperation contracts is the cost of supplying Western technical services, assistance and training in connection with plant installation and startup. While payments for such services are usually subject to separate remuneration, the levels of compensation rarely cover the actual salary, not to mention overhead costs, of highly skilled Western personnel.

Indeed, it is not hard to understand that in countries where the manager of a factory may be earning less than \$400 a month, there may be some reluctance to

pay Western technical experts \$4,000 to \$6,000 a month for on-site assistance. It is often wise, therefore, to anticipate this by allocating a percentage of the cost of services to other elements of the contract where such costs can be more easily rationalized by the Eastern side.

A final topic which I would like to address briefly is that of financing hard currency costs. The subject is a complex one and will be treated in depth in a separate session of this Institute. However, there are a few general comments which are needed here as well.

As you know, East-West industrial projects can range in cost anywhere from less than a million dollars to more than a billion. In most multi-million dollar projects, medium- to long-term credits are required to finance initial hard currency outlays, although there have been some significant recent exceptions where the Soviet Union has agreed to pay cash for rather sizable projects.

These credits, as well as credit guarantees, have been obtainable on favorable terms from private banks and government agencies in Western Europe, Japan, and subject to some well-known limitations, the United States. In some instances, credit is arranged on a government-to-government or bank-to-bank basis. However, in many cases it is the Western party himself who arranges the credit facilities, either by extending his own commercial credit without recourse to a banking institution, or by seeking private bank credit with or without government-sponsored export credit guarantees and insurance facilities.

If such credits are to be repaid by the Eastern party in cash at fixed dates, with payments guaranteed by their foreign trade bank, there should be no substantial difficulties. The credit worthiness of most of the Eastern countries is considered to be excellent and their promissory notes and other debt instruments are readily discountable in the West. The only concern here is to work into the price of the contract the spread between the cost of private financing and the interest charges which Eastern parties are willing to pay. With falling interest rates, this, too, is becoming less of a problem.

Problems can arise, however, in projects which contemplate Western counterpurchases of products manufactured with the supplied equipment and technology. In such cases, particular attention should be paid to avoid any contractual link between the Eastern party's financial obligations and the Western party's counterpurchase commitments. Where such a link exists, it is often impossible to obtain an unconditional guarantee from the foreign trade bank for cash repayments of the credits extended, with the result that the transaction becomes unbankable in the West and unmanageably expensive for the Western party.

Let me conclude at this point with my thanks for your kind attention.