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GORDON L. ELICKER*

Western Joint Ventures to Carry Out Industrial Cooperation Agreements in the Soviet Union: Selected Problems for United States Parties†

Introduction

Industrial cooperation agreements (ICAs) in the Soviet Union take a variety of forms, the most frequently encountered being co-production and specialization, subcontracting, licensing, and sales of equipment and technology for entire plants. It is in this last category that it is most common to find two or more western enterprises joining together to carry out the project. Typically a single Western party will sign a contract, as the prime contractor, with a Soviet foreign trade organization (FTO) to provide equipment, related technology, advisory services regarding plant construction and the installation and erection of the equipment, training, and appropriate warranties of the equipment and of the quality and output of the plant. The prime contractor may then, in a separate agreement, share its responsibilities, liabilities and profits with one or more other non-Soviet companies. Generally, the FTO will neither be a party to this latter agreement nor be bound by its provisions. This article will examine some of the major problems which United States parties encounter in structuring joint business undertakings of this type to carry out an ICA which only one of the non-Soviet parties may have signed. Though most of the comments are applicable to other types of ICAs, these other types will not be specifically considered. In addition, this article will not give special attention to compensation arrangements where all or a portion of

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the purchase price of the plant is, in effect, paid for with output from the plant or with other commodities, goods or services.

Joint business undertakings between otherwise independent companies are commonly used throughout the world to carry out large industrial projects. The principal reasons motivating a United States contractor to involve another company in carrying out an ICA with a Soviet FTO include the following:[1]

a. By combining diverse skills, know-how, technical resources or experience, two companies can often provide goods or services that neither could provide separately. Further, the combined companies may be able to provide goods or services more efficiently and more cheaply.
b. A United States contractor may feel that it is unable or unwilling to assume the risks and potential liabilities inherent in a given project and will bring in a partner to share those risks and potential liabilities.
c. United States tax laws may make it advantageous for a United States contractor to utilize a foreign joint venture company in which it owns fifty percent or less of the equity.
d. With the present unavailability of United States government supported export financing from the Export-Import Bank of the United States (Eximbank) and the limited amount of private bank financing available in the United States on terms competitive with export financing obtainable abroad, the participation of a foreign company in the project, as a supplier of goods or services from its home jurisdiction, may make it possible to obtain government supported export financing or facilitate private bank financing of those goods and services (and possibly for other goods and services for the project) in the foreign company's home jurisdiction. In addition, even if adequate financing were available in the United States, it might prove advantageous for the American contractor to involve a company in a given country where local financing is available, if the Soviet Union has credit balances in the currency of that country which could then be utilized.

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[1]Western companies planning to engage in projects or markets outside the Soviet Union will frequently use joint ventures for reasons other than those listed in the text. For example, the government of the host country where a project is to be located may require the participation of a local partner in facilities being constructed. Tax or other advantages may be available where a local entity participates directly in the project. Giving the foreign company a stake in the success of the local enterprise (such as through participation in ownership or profits) is considered by many countries to provide significant advantages over the simple purchase of facilities and know-how. It may, for example, assure a long term relationship with the continued availability of expertise and updating of technology. Certain Eastern European countries other than the Soviet Union permit forms of these types of joint ventures. Also, where a company wishes to enter and operate in a particular industry or geographic market, the risks and capital requirements to enter and operate in that market may be so high that it is not willing to undertake the risk and investment alone and may involve a partner to share them.

I. Types of Joint Ventures

Joint business undertakings may take a variety of forms, all of which might be loosely characterized as joint ventures.

Contractual arrangements between the parties which do not rise to the status of a partnership may be considered to be joint ventures. For example, a prime contractor subcontracting to a major supplier significant portions of the work to be performed on an ICA might be characterized as a joint venture.

Where it is feasible to clearly allocate project responsibilities between the co-venturers, the contract which governs the relationship of the co-venturers as between themselves may specify the project responsibilities of each party and allocate the compensation attributable to those responsibilities. Normally, each party will indemnify the other against liability arising out of the performance by the first party of its project responsibilities. This type of arrangement is referred to as a "compensation-split" joint venture, and, if properly structured, would probably not be a partnership under the laws governing business associations in the United States or for United States tax purposes.

Where there is a pooling of effort and/or capital with a proportionate sharing of profits and losses, the joint venture will normally result in the creation of a partnership unless the parties have determined to carry out the venture through a separate jointly-owned corporation.

Choosing the appropriate type of joint venture in United States-Soviet trade requires consideration of essentially the same factors as in selecting similar joint ventures elsewhere in the world. For example, the nature of the project and each party's project responsibilities, the host country and its laws, the methods of doing business and the corporate structure of each co-venturer, the overall tax situation of each co-venturer, the forms of doing business which are permissible and most advantageous in the various jurisdictions which might be chosen to govern the joint venture, the terms on which required financing may be obtained, and the terms of instruments governing indebtedness of the co-venturers, may all influence the choice of structure in a particular joint venture.

The remainder of this article will elaborate upon some of the major problem areas encountered in joint ventures (to which the FTO is not a party) to carry out ICAs signed by one of the co-venturers for sales of equipment and technology for entire plants, with some illustrations of how certain of the foregoing considerations may affect the structure of the joint venture.

II. Financing

The type of financing which is available and the currency in which it is available may be determinative of, or at least significantly influence, the structure of a joint venture. At the present time, the only types of financing available for an ICA between a United States company and a Soviet FTO are private bank financing without government credit support (United States or foreign) and foreign government supported export financing (normally available only to finance the export of goods or services from that foreign country or to assure availability to that country of foreign sources of raw materials).[2]

Currently there appears to be significant lending capacity available at private United States banks to finance United States-Soviet trade. However, because of limitations on United States banks lending to any one borrower, there is considerable uncertainty as to the upper limit on credit available at United States banks to finance this trade (in the absence of Eximbank credit support).[3] Federally chartered banks in the United States (which, in general, are the most significant international private bank lenders in the United States) are prohibited from lending more than ten percent of their capital and surplus to any one borrower.[4] How this prohibition would be applied to borrowing entities in Socialist countries such as the Soviet Union is unclear. Depending on the circumstances, loans and credits to one or more (and possibly all) Soviet Union entities may have to be treated as made to a single borrower.[5] In the case of Soviet FTOs, insufficient information concerning

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[2]Supplier (or trade) credit is not a practical financing alternative in ICAs in light of the size of indebtedness involved and the length of term for repayment. Eximbank credit support for Soviet ICAs is currently prohibited by statute. Trade Act of 1974, § 402, 19 U.S.C. § 2432 (1976); Export-Import Bank Act of 1945, 12 U.S.C. § 635 (b) (2) (1976). Eximbank supported credit for ICA-type projects (through direct Eximbank loans, or guarantees or insurance for commercial bank loans) will normally not involve reliance on the credit of the United States contractor. Consequently, if this source becomes available in the future, it will normally not affect the type of structure a United States contractor would choose in performing an ICA with a Soviet party. party.

Restrictions under the Johnson Act of 1934, 18 U.S.C. § 955 (1976), and regulations under the Trading with the Enemy Act, 50 App. U.S.C.A. § 5(b) (West Supp. 1979), should be considered in connection with any proposed financing by United States private banks of a Soviet ICA. The Johnson Act prohibits "persons" in the United States from making "any loan" to or purchasing or selling "the bonds, securities, or other obligations of any foreign government . . . in default in the payment of its obligations . . . to the United States." The Soviet Union is considered in default under this Act. The Act's prohibition does not apply to any transaction in which the Eximbank participates, 12 U.S.C. § 635(h) (1976), and it has been interpreted not to apply to bank and commercial credit arrangements on normal commercial terms, if directly tied to specific export transactions. 37 OP. ATT'Y GEN. 505 (1934); 42 OP. ATT'Y GEN. 299 (1963); 42 OP. ATT'Y GEN. 357 (1967). Although this interpretation of the Act, on its face, appears to remove most barriers to arms length financing by United States banks of Soviet ICAs, the uncertainty as to what are normal commercial terms, among other questions, means that the terms of each proposed financing must be carefully reviewed by counsel. In addition to the Johnson Act restrictions, the Transaction Control Regulations, 31 C.F.R. Part 505 (1978), promulgated under the Trading with the Enemy Act, may be relevant. Under these Regulations the sale or financing of specified strategic goods in a foreign country for shipment to the Soviet Union would require the specific authorization of the United States Department of the Treasury unless the shipment is made from and licensed by one of the United States allies listed in the Regulations.

[3]Obligations to national banking associations which are fully guaranteed both as to principal and interest by the Eximbank are not subject to any limitation based upon the capital and surplus of the association. 12 C.F.R. § 6.2 (1978).

[4]12 U.S.C. § 84 (1978). Banks chartered under state law are, in general, subject to similar restrictions.

[5]The criteria applied by the Comptroller of the Currency are set forth in 44 Fed. Reg. 22712 (1979) (to be codified in 12 C.F.R. § 7.1330). In general terms, loans to foreign governments must be combined with loans to their agencies and instrumentalities unless the borrowing entity is sufficiently separate from the government to have separate and independent existence apart

their respective financial conditions and operations has made it extremely difficult, if not impossible, to determine if the criteria for treatment as an entity eligible for separate borrower status have been met in any given case. However, even if all loans to Soviet entities are treated as made to a single borrower, as was mentioned above, there is apparently significant lending capacity presently available at private United States banks. If levels of trade between the United States and the Soviet Union increase significantly in the future and Eximbank financing continues to be unavailable, these lending restrictions may pose a serious obstacle to United States private bank financing of this trade unless the necessary criteria can be satisfied for more than one borrower.

Because of the availability of government supported export financing outside the United States, which will generally be provided on more favorable terms than would be available in a United States private bank financing, American contractors will frequently seek foreign joint venture partners or subcontractors to provide machinery, equipment and services in connection with a Soviet project.

If foreign government credit support is available it will normally be provided directly to a borrowing entity in the country where the project is located or by guarantees or insurance not involving the credit of joint venture partners. This largely eliminates the need for the lending governmental agency to concern itself with the particular structure of the joint venture. Nonetheless, in some instances the foreign government export financing agency may seek to impose conditions on the structure of the joint venture or the relationship between its national supplier and the United States contracting party in order to minimize the risk that acts of the United States party could affect repayment of the loan or result in liability of the national supplier.

Where financing is provided by private banks (United States or foreign) it is customary to use more complicated financial arrangements which may cause a United States contractor to structure the joint venture in a different manner.

Loans to Soviet FTOs are normally guaranteed by the Bank for Foreign Trade of the U.S.S.R. (*Vneshtorgbank*). Because of the high credit rating of the *Vneshtorgbank*, private banks are generally willing to lend to non-Soviet contractors on a non-recourse basis (except as described below), taking as security promissory notes of the FTO guaranteed by the *Vneshtorgbank*.[6]

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from the central government and also satisfies both "means" and "purpose" tests. Briefly, the "means" test requires the borrowing entity to "have resources or revenue of its own sufficient over time to service its debt obligations" and the "purpose" test requires the proceeds of the loan to be used by the borrowing entity "for a purpose consistent with the borrower's general business."

[6] *Vneshtorgbank* customarily requires that it be given a right of first refusal to purchase any promissory note it has guaranteed prior to a proposed negotiation of the note. This requirement limits the liquidity of the investment in these notes and detracts somewhat from their desirability to lenders.

These notes customarily bear interest at fixed rates. However, because private banks are generally not willing to lend long term at fixed interest rates which are competitive with rates provided by government supported export financing, interest on the loan will normally be tied to the fluctuating market rate. To the extent that the fixed rate notes of the Soviet FTO are inadequate to cover the interest, the United States contractor or the joint venture partners will guarantee repayment of the interest differential.

These arrangements will normally be embodied in a note purchase agreement under which the bank lenders will become holders in due course of the notes, free of claims by others (including creditors of the joint venture partners), and the joint venture partners will not have to treat the purchase price of the notes as loans for purposes of financial statements or financial covenants in loan instruments to which they are parties. However, in certain circumstances the arrangement may be viewed as a loan secured by an assignment of the notes as collateral. Factors such as the lenders preserving specified rights of recourse against the co-venturers in case of nonpayment by the Soviet FTO and the inclusion of financial covenants restricting the joint venture partners might indicate that the credit of the co-venturers was relied upon and the assignment of the notes was only for collateral purposes. This could result in the co-venturers being required to treat the arrangement as a loan for both financial statement purposes and purposes of financial covenants in their loan instruments. It may be possible to avoid this problem through the use of a separate corporation, not backed by credit support of the co-venturers,[7] as the entity selling the Notes to the bank lenders.[8] Use of a separate corporate financing vehicle would not normally require a significant modification in the relationship between the United States contractor and any other joint venture partners or subcontractors which might be involved in the project.

III. Taxation

Tax considerations play a major role in determining the structure which a joint venture will take. It is beyond the scope of this article to examine the internal corporate tax reasons a co-venturer might have for favoring a particular structure[9] or the tax considerations to be taken into account in light of the recent Soviet decree concerning taxation of income of foreign legal entities and individuals.[10] The present discussion will be limited to the differences

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[7]Except possibly the guarantee of the interest differential, which, if material, would probably only have to be reflected in a footnote to the co-venturers' financial statements as a contingent liability.

[8]The acceptability of this structure to lenders and (depending on the circumstances) the Soviet FTO will, of course, have to be considered.

[9]*See generally* Glickman, *Problems of the Corporation as a Joint Venturer*, 35 N.Y.U. INST. FED. TAX 581 (1977).

[10]Decree of the Presidium of the Supreme Soviet of the USSR of May 12, 1978 ("concerning income tax of foreign legal entities and individuals"), Vedomosti Verkhovnogo Soveta USSR

in United States tax treatment of the various types of joint ventures and the effect of the United States-Soviet Union Income Tax Treaty[11] on the choice of a joint venture structure.

Under United States tax laws a joint venture (in the broad contractual sense we have been using the term)[12] between two parties to perform an ICA will normally be considered either a simple contract, a partnership, or a corporation or an association taxed as a corporation.[13]

If the joint venture is found to be a simple contract (for example, the classic relationship between a prime contractor and a subcontractor) there would normally be no concept of sharing the overall income relating to the project. The determination of income to be derived by each party would not be based on a single contractual arrangement but rather on separate arrangements embodied in separate documents (the prime contract and subcontract). The subcontractor's income would be determined in its subcontract without reference to the level of profit received by the prime contractor (although the subcontractor's right to receive payment might be conditioned on receipt of funds from the FTO). The prime contractor's income would be determined by reference to the compensation received under the ICA less his costs (including payments to the subcontractor).

Where a joint venture involves the sharing of profits and losses, mutual control of the business or the active conduct of business, a partnership may be found for tax purposes. Such a partnership has tax consequences significantly different from those joint ventures which are treated as mere contractual arrangements. For example, under joint ventures categorized as mere contracts (or co-ownership), each co-venturer's income from the venture will be determined separately (and not by reference to the overall income or loss of the joint venture), certain elections (for example, methods of depreciating assets) may be made independently by each co-venturer without requiring that they be consistent with elections made by other co-venturers, and no separate tax return will have to be filed as to the joint venture. In a partnership, however each partner's taxable income from the partnership will be determined in accordance with his share of the partnership's income or loss,

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(Gazette of the Supreme Soviet of the USSR) 1978, No. 20, art. 313 [hereinafter cited as Tax Decree]. The Decree is translated, described and discussed in Maguire & Stein, *USSR: New Income Tax on Foreign Legal Entities and Individuals,* TAX MANAGEMENT INT'L J., Sept., 1978, at 3.

[11]Convention on Matters of Taxation, June 20, 1973, United States — U.S.S.R., 27 U.S.T. 1, T.I.A.S. No. 8225 [hereinafter cited as Treaty].

[12]The United States Internal Revenue Code (the "Code") does not define the term "joint venture." Code §§ 761(a) and 7701(a)(2) include a joint venture within the definition of a partnership. Consequently, in situations where it is not desired that the joint business activity be treated as a partnership, use of the term "joint venture" should probably be avoided.

[13]A fourth category of joint ventures is "co-ownership" of property. Although the line between co-ownership and partnership is not clear, the primary consideration appears to be the degree of business activity of the co-owners or their agents. Since it is highly unlikely that a joint venture to carry out an ICA would not involve a significant level of business activity a finding of co-ownership is highly unlikely and will not be discussed.

partners will be bound by certain elections made at the partnership level, and separate partnership tax returns are required.

Where there is a foreign co-venturer, a finding that the joint venture is a United States partnership[14] will probably result in the foreign co-venturer being deemed to have a permanent establishment in the United States within the meaning customarily given to that term under United States tax treaties. In addition the foreign co-venturer will probably be deemed to be engaged in United States trade or business, and might be found to have United States taxable income computed in accordance with its share of the partnership's income or loss. Thus, if the foreign partner wishes to avoid having United States taxable income from the venture, the agreement governing relations with the United States co-venturer must be carefully drawn to assure that the arrangement is in a non-partnership contract form, such as a prime contractor-subcontractor arrangement or a compensation-split joint venture as described earlier.

If the pass through of income and losses of the joint venture to the co-venturers is an essential goal of the venture, care must be taken in structuring the arrangements so that it is not characterized as an "association taxable as a corporation" under the Code. When an unincorporated association has too many of the characteristics of a corporation, the Code generally requires that it be taxed as if it were a corporation.[15] The criteria examined are:

1. associates;
2. an objective to carry on business and divide the gains therefrom;
3. continuity of life;
4. centralization of management;
5. limited liability; and
6. free transferability of interests.

The first two characteristics are common to partnerships and corporations and thus are not determinative. The United States Treasury Department has arbitrarily taken the position that if at least three of the other four characteristics are present the arrangement will be deemed an association taxable as a corporation.[16] By careful drafting, usually by limiting the life of the venture and the transferability of its interests, the normal joint venture can obtain partnership treatment.

Use of a joint venture corporation usually precludes partnership treatment. A corporation will allow the co-venturers to avoid having income and losses of the venture reported directly by the co-venturers. At the same time, the assets of the co-venturers can be isolated from the risks and liabilities associated with the project, except to the extent individual guarantees by the co-venturers may be required. It may also be possible to achieve significant deferral of United States taxation of joint venture income by incorporating the joint venture vehicle in a low tax foreign jurisdiction. Complex provisions

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[14]Assuming some significant level of partnership activity in the United States.

[15]Treas, Reg. § 301.7701-2(a)(1) (1960).

[16]*See* Treas. Reg. § 301.7701-2(a)(2), (3) (1960).

in the Code must be carefully reviewed in such cases and United States tax authorities will probably scrutinize the structure.

However, the use of the corporate form has the disadvantage of not allowing the co-venturers as much flexibility in the treatment of joint venture income, expenses, and the like to account for their respective tax situations as would the non-partnership forms discussed above. In addition double taxation of at least some portion of joint venture income may result.

In structuring the joint venture, consideration must be given to applicable tax treaties. It is my understanding that the Treaty[17] is the only comprehensive income tax treaty in effect between the Soviet Union and a Western country. As long as no tax treaty exists between the Soviet Union and the country of the non-United States co-venturer it might prove advantageous to structure the joint venture so that it could benefit from the Treaty. The absence of a treaty between the Soviet Union and the jurisdiction of the non-United States co-venturer may result in income of the non-United States co-venturer being subject to taxation in the Soviet Union under the recent Tax Decree.[18]

If the income to the joint venture were treated as income of a "resident" of the United States it would benefit from the exemptions from Soviet taxes provided in the Treaty. If the relationship between the United States partner and the foreign partner were one of prime contractor-subcontractor it seems reasonably clear that the Treaty requirements would be satisfied. If a joint venture agreement were treated as a compensation-split joint venture and not a partnership for United States tax purposes, it would probably not be a separate entity for purposes of the Treaty and it seems unlikely that the foreign partner could benefit from the provisions of the Treaty. If the joint venture were considered a partnership for United States tax purposes it would similarly not be treated as a separate entity, but then a foreign co-venturer not otherwise engaged in United States trade or business might be subject to the United States income tax as described above.

IV. Antitrust

When two or more companies which compete with each other in a given product or industry, or are capable of so competing, come together in a joint venture, the opportunity for abuse of power is increased. Companies contemplating such a joint venture must carefully examine the purposes of their joint activity, the effect of the joint venture on competition, the manner in which it is carried out and the impact of these activities on participants out-

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[17]Treaty, *supra* note 11.

[18]Tax Decree, *supra* note 10. A carefully worded tax indemnity clause in the ICA can satisfactorily minimize or eliminate this risk. However, the Soviets are, in general, not accustomed to dealing with the complicated tax concepts of countries such as the United States, which may lead them to resist inclusion of a sophisticated indemnity clause in the ICA. If an imperfect indemnity clause is accepted, structuring the joint venture to assure availability of the Treaty exemption becomes more important.

side the scope of the joint venture to be sure the venture does not violate the prohibitions of relevant United States antitrust laws or foreign competition laws.

For the United States antitrust laws to apply to the activity of a joint venture there must be a significant adverse impact on United States commerce. It is not necessary for the parties to be nationals or residents of the United States or for the activities to have taken place on United States territory so long as there is an adverse impact on United States commerce. Where two competitors join together for valid reasons (such as achieving economies of scale, sharing risks or bringing together complementary expertise), and only foreign competition is reduced, the joint venture is usually not challenged. Joint ventures which are limited in scope and time to a single project, such as those to perform most ICAs with the Soviet Union, present significantly less risk of antitrust violation. Consequently, to date United States antitrust laws have not presented special problems in structuring joint ventures to carry out ICAs in the Soviet Union.

Areas where United States antitrust enforcement authorities are most likely to scrutinize joint ventures for industrial cooperation with the Soviet Union are as follows:

1. The joint venture might present the opportunity to exchange information about matters outside the scope of the joint venture (for example, pricing policies in other markets or for other goods and services) which could be viewed as a conspiracy to restrain trade;
2. Joint selling abroad might be viewed as restraining independent export competition out of the United States; however, if the joint selling produced no adverse effect on United States consumers or competitors, it is unlikely to be challenged;
3. ICAs may involve counterpurchase arrangements. These arrangements might be viewed as joint buying arrangements and would have to be evaluated separately under the antitrust laws. Generally such arrangements will not be challenged if they are not designed to encourage higher prices for the goods purchased and there are no agreements relating to domestic United States competition or to pass on price increases; and
4. Resale and re-export limitations in licensing or distributorship arrangements must be reviewed carefully; however, it is unlikely that such considerations will affect the structure of the joint venture.

In summary, if there are legitimate reasons for two or more companies to jointly undertake a project for industrial cooperation of limited scope and duration, it is unlikely that United States antitrust laws will be a major consideration in determining the structure of the joint venture, although individual contract terms—both in the joint venture agreements and the agreements with the Soviet FTO — will have to be reviewed carefully.

The co-venturers should endeavor to isolate the joint venture from other areas of their respective activities. This may be done by creating a separate entity with a separate staff or by at least endeavoring to assure that representatives of the companies in the joint venture do not have additional responsibilities in areas where the companies may compete with each other. Meetings and discussions of joint venture activities by the co-venturers should never extend outside the scope of the joint venture to areas where competition exists between the companies.

V. Relative Liability of Co-Venturers

The joint venture agreement will normally attempt to specify the liability of each party to the other. These provisions will deal with both the liability which the joint venturers may incur to the FTO and other Soviet parties, as well as the potential liabilities between the co-venturers independent of any obligation to the FTO or other Soviet party. Normally these provisions provide that any liability arising out of the performance by one co-venturer under the ICA shall be the sole responsibility of that co-venturer, who must then indemnify the other co-venturer against any resulting liability. Where it is difficult or impossible to allocate responsibility for performance of certain portions of the ICA to one of the co-venturers (for example, responsibility for production or quality guarantees where both parties have contributed know-how to the various steps of a complex production process), they may agree on a formula for sharing the liability.[19] If the structure of a joint venture is such that there is a general sharing of profits and losses, cross indemnity provisions might be inappropriate, at least in the absence of fault by a given co-venturer.

VI. Dispute Settlement

Disputes between the co-venturers which cannot be resolved amicably will normally be settled by arbitration, and a specific clause to that effect will appear in the joint venture agreement. American co-venturers will most frequently choose the rules of the American Arbitration Association, and frequently the specialized Construction Industry Arbitration Rules of that body, as the rules which will govern their arbitration. Similarly, where the joint venture is between a United States company and a foreign company, disputes will customarily be settled by arbitration. However, the choice of rules which will govern the arbitration will vary significantly from one joint venture to another, depending on the nationality of the participants, the matters which might be the subject of the arbitration, the law which governs the joint venture agreement, and a variety of other considerations.

If the law governing the ICA is the law of a neutral jurisdiction, such as Sweden, and arbitration under the ICA is to take place there,[20] it is sometimes

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[19]Note that the sharing of liability in question here is only as between the parties under the joint venture agreement. The liability to the FTO will be determined principally by the ICA to which, in all probability, only one of the co-venturers will be a party.

[20]Under the model arbitration clause *Optional Arbitration Clause for Use in Contracts in*

suggested that the law of the neutral jurisdiction should also govern the joint venture agreement, and any arbitration should be conducted by the same neutral body under the same rules as for the ICA. Disputes under the respective contracts could then be consolidated. Although this suggestion might, on first impression, have some appeal it would not seem to be a desirable approach from the viewpoint of either joint venturer.

The issue in the arbitral proceedings under the ICA will be the liability of the non-Soviet signatory of the ICA to the FTO. The FTO is not concerned with the relative liability of the joint venturers between themselves and that issue should not complicate the proceeding. In addition, the joint venture partners will undoubtedly prefer not to involve the FTO in the resolution of their internal dispute. As a result, a consolidation of the two proceedings would be inappropriate. Although certain factual issues may be essentially the same in both proceedings, there is no logical need to apply the same laws to both agreements. The issue of the sharing of liability to the FTO will be resolved by the manner in which responsibilities and liabilities are divided under the terms of the joint venture agreement. Although the joint venture agreement may refer to clauses of the ICA describing joint venture responsibilities (thereby possibly involving the law governing the ICA to interpret its terms), any advantage in using the same law to govern the joint venture agreement would seem clearly outweighed by the advantages of lower cost, convenience and familiarity if arbitration is conducted in the home jurisdiction of one of the co-venturers and under its laws.

If both joint venture partners are United States companies, a United States arbitration under the laws of some United States jurisdiction is preferable in terms of both convenience and familiarity with the law. Where an American and a foreign party are joint venture partners, it would seem preferable to have the laws of one of their home jurisdictions apply to the resolution of disputes under the joint venture agreement, unless it is felt that the chosen law would not apply in a neutral manner to both parties or it would be difficult for one party to be adequately and conveniently apprised of the law (for example, language or legal concepts not widely used in international commerce). If there is a predominant party in the joint venture, it will normally be the laws of its jurisdiction which will govern the transaction, with the arbitration being held in that jurisdiction, although it is sometimes proposed that the place of arbitration should be the country of the defendant in the arbitration. This latter approach has a tendency to deter parties from commencing arbitration proceedings since they would be arbitrating in the other party's home territory. Thus it may result in disputes going unresolved for long periods of time with the parties delaying performance, parrying to see who will bring the arbitration. Completion of the project will frequently suffer in such circumstances.

USA-USSR Trade—1977 (prepared by the American Arbitration Association and the USSR Chamber of Commerce and Industry), arbitration would take place in Stockholm, Sweden under UNCITRAL Arbitration Rules.

VII. Currency Risks

Where goods and services in connection with an ICA are provided by companies from more than one country, the currencies of at least two countries will normally be required to pay for those goods and services. If the ICA is denominated in a single currency, fluctuations in the exchange rate between that currency and the other currency in which costs are being incurred can result in gains or losses which will be difficult to predict, impossible to control, and, practically speaking, impossible to hedge against. Consequently, contractors will normally seek to have the ICA denominated in the currencies required, so that the price quoted to the FTO for performance of the ICA will not have to include a factor based on a speculative estimate of the impact of currency fluctuations. Of necessity, the foreign contractor will estimate this impact conservatively, possibly increasing significantly the quoted contract price.

The elimination of this factor from price discussions should work to the benefit of the FTO and the Soviet Union. The pricing discussions can then focus more clearly on the value of goods and services to be provided. To the extent conversion to a given currency is necessary to evaluate competing bids, a more accurate assessment will be made if Soviet authorities make that conversion themselves in light of anticipated foreign currency needs for the whole country, available foreign currency balances, and a consistently applied evaluation of future movements in currency markets, rather than relying on conservative evaluations of foreign contractors in multicurrency projects. Notwithstanding the merits of this reasoning from the Soviet viewpoint, FTOs are generally reluctant to consider denominating individual ICAs in more than one currency.

VIII. Interface of Soviet Planned Economy and American Market Economy

A major problem area which must be faced in every ICA between a United States company and a Soviet FTO is the interface of the Soviet planned economy and the American market economy. For budgeting purposes under the economic plans developed by the State Planning Committee (Gosplan) the FTO feels it must have a fixed total price for completion of a contract.[21] This necessity affects several aspects of the ICA negotiations.

To assure that financing costs can be known at the outset, FTOs will normally insist upon fixed interest rates in any financing provided. Although fixed interest rates can normally be obtained from government subsidized export financing institutions, it is extremely difficult to find medium to long

[21] Normally FTOs will not insist that fixed prices be quoted for spare parts to be supplied in the future. In addition, escalation based on economic indices is sometimes accepted, subject, nonetheless, to an overall ceiling. *Cf.* Hoya & Stein, *Drafting Contracts in U.S.—Soviet Trade*, 7 Law & Pol'y Int'l Bus. 293 (1975).

term private financing except at interest rates which fluctuate with current market conditions over the life of the loan. As was indicated earlier, if the contractor is required to take the risk of a difference between the fixed rate the FTO is willing to pay and the floating rate at which private banks are willing to lend, he must conservatively estimate the dollar amount of that risk and add it to his contract price.

If, in fact, the interest rates do not fluctuate in as adverse a manner as the contractor estimated, the FTO will end up paying more for goods and services than if it had assumed that risk itself. From the Soviet party's viewpoint, it would have been preferable to eliminate from its discussion with the United States contractor the question of evaluating the risk of this interest differential. The United States contractor will normally be happy to eliminate this issue from the negotiations since it will enable him to avoid estimating an amount which is both speculative and with respect to which he may have little expertise. Consequently this amount must be estimated very conservatively. The *Vneshtorgbank* could make such an estimate and it might be possible for the FTO to budget an amount to account for possible interest rate fluctuations. Any savings resulting from interest rates not reaching the conservatively estimated levels would accrue to the benefit of the FTO instead of being lost to the foreign contractor.

The desire to have fixed price contracts creates difficulties for the United States contractor in other areas. In a complex project the full scope of work will frequently not be known at the time the contract is signed. It will be known only when all engineering work has been completed and, in general, most American engineering firms are not willing to complete a substantial amount of the engineering prior to execution of the contract. Consequently, if a United States contractor is to provide a fixed quotation on all elements of the project before signature, it will have to conservatively estimate costs which would be shown by completed engineering work.

The problem of estimating costs is not limited to the engineering area. In the United States, particularly in an inflationary period, it can be extremely difficult to negotiate fixed price subcontracts for work on projects. Even where it has been possible to negotiate fixed price subcontracts, it is possible that the prime contractor may nonetheless have to pay escalation under those contracts. For example, if a shortage of supply develops, the subcontractor may be in a very strong negotiating position to obtain a price increase notwithstanding a fixed price contract. Without regard to a shortage of supply, if the subcontractor's costs have risen he may still be in a position to negotiate a price increase. The alternative to agreeing to a price increase may be to terminate the contract, sue for damages and find a replacement contractor, probably at an increased cost. Although the increased cost might be recovered from the old subcontractor, there would likely be significant delays in completion of work and possibly less warranty protection than would have been obtained from the original subcontractor. Consequently, the prime contractor may feel that it is preferable to agree to escalation with the original subcontractor in order to insure timely performance under the ICA with adequate guarantees. Because of this risk, the prime contractor must add to his estimate of costs under the ICA an amount designed to protect him against such possible escalation. The supplemental amount may, in fact, turn out to be unnecessary; however, the prime contractor will normally be unwilling to take this risk. The result may be that the FTO pays an excess amount which could have been avoided by allowing escalation or utilizing "cost-plus-fee" type contracts.

The considerations affecting relations between a prime contractor and its subcontractors outlined above apply with equal force to relations between the prime contractor and the owner. Fixed price contracts will not guarantee that the owner will be provided with a satisfactory facility, on time, and at a fixed cost. Most of the countries in the Middle East and North Africa can attest to the truth of this statement.

In the Middle East and North Africa in the late 1960s and early 1970s it was fairly customary to enter into fixed price construction contracts. Frequently, too great an emphasis was placed on the overall price and not enough attention was given to the reputation and abilities of the prime contractor (many of the major construction and engineering firms were unwilling to contract on anything but a "cost-plus-fee" basis). With the high rates of inflation in the early 1970s, many of these projects were delayed because of the contractors' unwillingness to incur expenses without obtaining agreed price increases from the purchasers.

In other cases goods of lower quality were used with the hope of remaining within budget. Frequently the owners were forced to agree to repeated price increases (largely converting the contract to a "cost-plus-fee" arrangement), to fire the prime contractor and seek a replacement contractor, or to accept a plant of lesser quality. When replacement contractors were found, they were unwilling to complete the projects on anything other than a cost-plus-fee basis and they were unwilling to provide meaningful guarantees of quality and production. Many of the former contractors had become insolvent or bankrupt due to their financial difficulties (arising to a significant extent from such contracts) and recovery of actual damages from them, even if they were found liable, was unlikely. Many of these problems might have been avoided by giving greater emphasis to the reputation and capabilities of contractors and being more flexible on the basis of compensation. If budgeting problems for Soviet FTOs could be satisfactorily dealt with, use of more flexible compensation arrangements in ICAs might give greater assurance of timely completion of projects with high quality materials and workmanship at a reasonable cost.

In summary, Soviet FTOs and American companies have found and will continue to find satisfactory means of interfacing the two economic systems. The emphasis on fixed price contracts by Soviet FTOs has unquestionably resulted in higher costs for the goods and services purchased. If greater flexibility could be built into the FTO's budgeting requirements a considerable savings to the Soviet Union could result and speculative elements in contract negotiations, which neither party has adequate control over or ability to predict, could be eliminated. Consideration might be given, for example, to treating these elements as insurable risks for which the FTO could pay an agreed premium to a central insurance body which would bear the risk in a manner similar to that done for other types of insurance in the Soviet Union. Additional alternatives consistent with the requirements of Soviet law and the Gosplan may also suggest themselves.