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Recommended Citation

Thomas B. McVey, *Countertrade and Barter: Alternative Trade Financing by Third World Nations*, 6 Md. J. Int'l L. 197 (1981).
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COUNTERTRADE AND BARTER: ALTERNATIVE TRADE FINANCING BY THIRD WORLD NATIONS*

THOMAS B. McVEY**

I. *Introduction*

A significant development in recent trade transactions involving Third World Nations is the increase in the use of barter and countertrade.¹ Barter, the simplest form of trade transaction, is the two-way exchange of goods effectuated without the use of currency. Countertrade, in comparison, is an agreement between an importing nation and a foreign seller requiring that, as a condition for the completion of the import transaction, the seller separately purchase certain goods from the importing nation.² Both are methods of effectuating the transfer of goods, services and technologies to nations experiencing hard currency shortages or low currency values. In response to new economic demands created by constantly changing international conditions, Third World Nations are turning with greater frequency to these and similar innovative methods of structuring their trade transactions in an effort to deal with the ever worsening problem of financing needed imports. This article is designed as an introduction to the concepts of barter and countertrade and as a preliminary guide to the use of these techniques in trading activities with Third World Nations.

Conditions Underlying the Recent Rise in Barter and Countertrade

At the root of the recent surge in barter and countertrade activities are the shifts in international economic conditions which have been responsible for the inability of many nations to adequately finance their import activities. The rapid increase in the cost of key imports has left importing nations with significantly diminished supplies of hard currency with which to

* Portions of this article have been adapted from a lecture presented by Mr. Mc Vey at an American Management Association seminar on the topic of countertrade and barter.

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1. The term "offset trade" is used by some businessmen in place of the term "countertrade," although "offset trade" is more frequently used to refer to a specific type of countertrade known as "compensation trade." See § II *infra*.

2. For more detailed definitions of barter and countertrade transactions as well as a discussion of the various types of countertrade, See § II *infra*.

meet their ever expanding industrial and social needs. This currency depletion is especially severe in non-OPEC Third World Nations which rely upon foreign energy sources for their sputtering national economies.³ These problems have been exacerbated by protectionist "import relief" measures taken by Western nations in the effort to bolster key domestic industries and protect segments of their respective labor forces from the lower priced Third World imports.⁴ Such import relief measures have further reduced the currency generating capabilities of the Third World Nations, thus further impairing their hard currency positions.⁵ With their borrowing capabilities strained to the breaking point, Third World Nations have been forced to devise new methods of dealing with their currency shortages and meeting import finance obligations.

Barter and countertrade have increasingly been employed as means for overcoming or significantly reducing the above stated economic pressures. Their application is exemplified by the following hypothetical: Brazil, when negotiating the purchase of a product from a U.S. manufacturer, will seek to impose a barter or countertrade requirement as a condition to completing the underlying transaction. Under a barter requirement, the manufacturer must agree to accept a product or commodity (often a surplus product with exhausted sales capabilities or of inferior quality) instead of currency as payment for the purchase of the manufactured goods. Thus, Brazil will be in a position to purchase the product without the need of currency by conveying a product which it might otherwise be unable to sell in the international market-place. The U.S. manufacturer would prefer to be paid in currency, but will consent to the barter requirement if the failure to do so would jeopardize the completion of the transaction. In the countertrade transaction, Brazil will require that in order to complete the sale, the seller must agree to purchase a certain quantity of raw materials or component parts (typically of a less desirable quality or in lower demand) from Brazilian sources. In essence, Brazil pays in currency for the manufactured product, but shortly thereafter is repaid the currency through the seller's "counterpurchase" of the agreed upon Brazilian products, thus insuring a stable currency position without the

3. See generally Organization For Economic Co-Operation and Development, *Workshop on Energy Data of Developing Countries (Colloque Sur Les Donnees Energetiques Dans Les Pays En Development)*, Volume II, Basic Energy Statistics and Energy Balances of Developing Countries, Paris, 1979; International Energy Agency, Organization for Economic Co-Operation & Development, *Crude Oil Import Prices, 1973-1978*, Paris, 1979.

4. See, e.g., U.S. countervailing and antidumping duties provisions set forth at 19 U.S.C. § 1671 *et seq.* (1978).

5. See Pompiliu Verzariu, Jr., "Countertrade, A Summary for Executives," *LES Nouvelles*, Licensing Executives, December 1980.

forfeiture of the imported goods or technology. Once again, the U.S. manufacturer would most likely prefer a conventional form of dealing, but will consent to a countertrade requirement if necessary to complete the transaction. Clearly, the imposition of either the barter or the countertrade requirement assists in expanding Brazil's export activities by placing the burden of selling its product on the U.S. company and drawing upon the company's marketing resources in broadening the exposure of the Brazilian products in the international market place.

Examples of recent barter transactions with Third World Nations include: the sale of a U.S. manufactured atomic research reactor to Ghana in exchange for quantities of Ghanaian lumber,⁶ the sale of U.S. manufactured tractors to the government of the Sudan in exchange for Sudanese cotton,⁷ and the sale by a U.S. company of phosphate rock to Poland in exchange for Polish molten sulfur.⁸ Examples of countertrade transactions include the sale of U.S. produced passenger jet aircraft to Yugoslavia in exchange for the subsequent repurchase of certain finished goods including, *inter alia*, canned hams and tools,⁹ and the development of a phosphate mine in Morocco in exchange for the repurchase of phosphate rock produced from the developed mine.¹⁰

Although relatively new in Third World trading transactions, countertrade requirements have been common in transactions between private corporations and the Soviet Union, East European nations and, more recently, the People's Republic of China.¹¹ It is to these earlier transactions that businessmen and their attorneys can look to gain an understanding of the processes of barter and countertrade for use in dealing with other nations.¹² It must be kept in mind, however, that the nature of these

6. See Eldwood E. Parrish, "Offset/Barter Trading, A New Approach To International Business," *Economy*, March 1979, p. 8.

7. *Id.*

8. See Leo Welt, "Countertrade Gains Popularity As International Trade Tool," *Business America*, July 14, 1980, p. 13.

9. *Id.*, p 14.

10. See Weigland, "Countertrade In Chemicals," *Chemical and Engineering News*, August 14, 1978, at 32.

11. For a detailed list of approximately 280 countertrade transactions involving the Soviet Union, East Europe and the People's Republic of China, see, Pompiliu Verzariu, *Countertrade Practices in East Europe, the Soviet Union and China: An Introductory Guide to Business*, United States Department of Commerce, April 1980, pp. 78-102.

12. *Id.*

transactions is constantly evolving, and the businessman and his attorney must be ever vigilant for new and unexpected developments in this area.

Response by the Business Community

Obviously, barter or countertrade requirements often serve to alienate otherwise compatible trading partners and stand as a barrier to an untold number of transactions. Companies which are aggressive competitors in the international market place, however, are begrudgingly attempting to devise methods of meeting the increasing countertrade demands of the Third World in order to assure their continued presence in the international trade markets.¹³ Most companies attempt to resist the countertrade obligation, or when pressed, look to enter a "best efforts" arrangement before assuming the obligation of a full countertrade commitment. However, when put to the test, many companies would prefer to undertake a realistic barter or countertrade obligation if necessary in order to establish or continue sales relationships in the often lucrative Third World markets.

Companies submitting to barter and countertrade requirements are dealing with them in a number of ways. Companies will typically attempt to limit the products which they agree to purchase to those which they can use internally. The company will look to purchase products which it can use in its manufacturing process, such as raw materials or component parts, or occasionally, office equipment or goods suitable for distribution to its employees. As a generally less desirable alternative, the company will look to take back goods in anticipation of resale on the international market. This resale is generally accomplished through either the utilization of an in-house trading arm or the transfer of the countertrade obligation to an outside trading house. As a result of the increased frequency of the imposition of counterpurchase requirements and the use of in-house trading subsidiaries, the in-house trading company is becoming an increasingly significant component in the overall corporate structure.

II. DEFINITIONS

Barter

As introduced above, the barter transaction consists of a simple exchange of goods. Under the basic barter transactional format, both parties present

13. United States companies active in barter and countertrade activities include, *inter alia*, Lockheed Corp., Rockwell International Corp., General Motors Corp., RCA Corp., Occidental Petroleum Corp., McDonnell Douglas Corp., International Harvester Co. and Levi Strauss and Co.

goods of equal value and undertake a simultaneous two-way trade. Typically, hard currency is not exchanged and one contract is utilized to formalize the agreement between the parties. In more complicated barter transactions, there can be three or more parties, the exchange can take place over a longer period of time and currency can be utilized to offset variations in the values of the bartered goods. Barter transactions can be between private parties, between a private party and a sovereign nation,¹⁴ or between sovereign nations.¹⁵

Countertrade

The countertrade transaction consists of a parallel set of obligations wherein the parties each undertake to sell goods or technology to the other in separate but related transactions. Countertrade can best be understood as a two step process. First, the "seller," typically a private corporation [the "first party"] agrees to present its goods to the "buyer," typically a governmental purchasing agency in a Communist or Third World country [the "second party"] for an agreed upon purchase price in hard currency. Second, the first party then agrees, as a condition of the completion of this first transaction, to purchase goods supplied by the second party, again in exchange for hard currency. In essence, the second party agrees to purchase goods from the first party *upon the condition that* the first party agrees to purchase goods from the second party. The two obligations are "linked" or "cross-referenced" to each other by either a provision in one of the two agreements or in a separate document (typically referred to as a "protocol"). While the two obligations are often negotiated at the same time and part of the same overall commercial setting, the two should be viewed as distinct transactions with separate contracts and separate currency payments. The significance of the structuring of the transaction in this manner, as well as the use of the protocol, is explained below.

Types of Countertrade

There are a number of distinct types of countertrade transactions and an additional number of more complex countertrade "variations."¹⁶

14. See examples cited in text *supra*, at 199.

15. Examples of barter transactions between sovereign nations include: the exchange of wheat and frozen veal from Argentina for iron pellets from Peru; the exchange of a \$585 million steel making complex from Germany for crude oil from Indonesia.

16. For excellent discussions of the various types of countertrade transactions and variations thereof, see Welt, *supra* note 8; and Verzariu, *Countertrade Practices in East*

1. *Counterpurchase*. In a counterpurchase transaction, the first party agrees to sell goods to the second party and under a separate but related agreement undertakes to purchase other, unrelated products from the second party.¹⁷ Typically, the first party agrees to provide a specified product under certain conditions of quality, quantity, and time and place of delivery. In turn, the first party is required to purchase a certain "dollar value" worth of designated goods (usually designated in terms of a percentage of the contract price under the first obligation) and is permitted a certain time period in which to fulfill its purchase obligation.¹⁸ In addition, the first party is often permitted to select the items it will purchase from a list of goods agreed upon at the time the parties enter into the counterpurchase transaction.

2. *Compensation (Cooperation or Buy back)*. In a compensation transaction, the first party agrees to sell machinery, equipment, technology, or a turnkey plant ("equipment/technology") to the second party, and the first party separately agrees to purchase from the second party a predetermined amount of the product manufactured from the equipment/technology.¹⁹ Generally, the second party pays for the equipment/technology in currency and receives payments in currency for its sale of the product to the first party. (An alternative form of this type of transaction is for the second party to "pay for" the equipment/technology by shipping the product to the first party in lieu of a cash payment, *i.e.*, as a royalty. This variation, however, constitutes a cooperative barter transaction which is somewhat more difficult to structure and finance than a straight "cash" compensation transaction). In addition to serving as a mechanism for increasing exports of the second party, the compensation transaction provides an alternative means of financing the establishment of new industrial activity as well as stimulating the development and transfer of technology.

Countertrade Variations

1. *Reverse Countertrade*. Reverse countertrade is an arrangement whereby a nation with supplies of a scarce commodity (typically a Third

Europe, the Soviet Union and China: An Introductory Guide to Business, supra note II; see also forthcoming publication by Leo Welt entitled Barter and Countertrade, Welt Publishing Co., Washington, D.C., expected release: mid-1981.

17. See note 16 *supra*. An example of this type of transaction, as set forth on p. 5 *supra*, is the sale by a U.S. company of jet aircraft to Yugoslavia in exchange for the subsequent repurchase by the U.S. company of Yugoslavia canned hams, tools and other finished goods.

18. One to three years is common.

19. See note 16 *supra*. An example of a compensation transaction, as set forth on p. 199 *supra*, is the development of a phosphate mine in Morocco in exchange for the right to repurchase phosphate rock produced from the mine.

World OPEC Nation with abundant supplies of crude oil) imposes a requirement that in order for a foreign party (*i.e.*, a private multinational oil company) to purchase the commodity, the foreign party must agree to sell to the nation another scarce commodity otherwise unavailable to the selling nation, or to undertake a financial investment in the nation. A recent example of such a transaction is the arrangement wherein several major U.S. oil companies invested in refining and related petrochemical plants in Saudi Arabia in exchange for the right to receive additional quantities of crude oil on a long term contract basis.²⁰

2. *Swap*. A "swap" transaction is a "short-cut" method employed by four parties to reduce transportation charges.²¹ An example of this type of transaction is where a U.S. company has contracted to sell a certain ore to a South Korean steel company, while a Mexican company has agreed to purchase the same type of ore from Australia. Under the terms of the swap, the U.S. company delivers its ore to Mexico, while the South Koreans and Australians undertake the same exchange. The result is that each purchaser obtains the designated commodity with a substantial savings in transportation costs.

3. *Commodity Exchange Agreements*. Often nations will enter into bilateral agreements wherein they agree in principle to purchase certain quantities of the other party's goods within a specified period of time. These agreements are referred to as commodity exchange agreements and constitute, in essence, countertrade agreements between sovereign states.²² Commodity exchange agreements often set the framework for specific individual subordinate trade contracts between the states themselves, their subordinate economic units (purchasing agencies, etc.) or private enterprises within their territorial jurisdiction.

4. *Switch*. A "switch" transaction is a three-way transaction wherein the first and second parties are nations which have entered into a bilateral commodity exchange agreement, but the second party later finds that it lacks the hard currency to fulfill its obligation under the agreement.²³ The second

20. One major U.S. company invested \$300 million in an export refinery and an additional \$300 million in a petrochemical complex in Saudi Arabia in exchange for the right to be able to purchase an additional 1.4 billion barrels of Saudi crude over a 15 year period. See Robert C. Goodwin, Jr., "Scheduled End of U.S. Controls Muddies Oil Picture," *The Legal Times of Washington*, January 19, 1981.

21. See note 16 *supra*.

22. *Id.*

23. *Id.*

party then sells its product (which presumably the first party is not interested in purchasing) to a third party, and the third party either undertakes a currency payment to the first party or delivers goods acceptable to the first party in order to satisfy the prior bilateral obligation of the second party.

As will be discussed at greater length below, the three major types of barter/countertrade transactions are: (1) pure barter, (2) counterpurchase, and, (3) compensation. This article focuses primarily on the counterpurchase transaction, since the elements of this form of trade best typify the basic elements of the countertrade transaction and can be easily modified for use with the other types of transactions set forth above. In addition, both barter and compensation will be discussed briefly to point out a number of characteristics unique to each.

III. THE COUNTERPURCHASE TRANSACTION

Mechanics of the Counterpurchase Transaction

1. *Generally.* In essence, the counterpurchase transaction consists of two separate purchase agreements "linked" under a single heading or protocol. The agreements are separated to allow for separate financing arrangements and risk guarantees, as well as to insulate the obligations of the two transactions from each other. The linkage of the two agreements, however, performs the critical function of establishing the incentive for the first party to deal with the second party in the second transaction. Under most circumstances, the first party is not interested in purchasing the goods of the second party, but does so only as a condition of completing the underlying sale.

Typically, the two sales agreements are negotiated and executed simultaneously. As stated above, the first agreement generally consists of a standard contract for the transnational sale of goods where the first party agrees to provide a specified product under certain conditions of quality, quantity, time and place of delivery. A price is set and payment is generally called for in hard currency upon delivery. The second agreement, wherein the first party agrees to purchase goods from the second party, is often broader in scope and more loosely structured. Occasionally, the first party agrees to purchase a set quantity of specified goods at a firm price at the time of the completion of the first transaction. It is more common, however, for the second agreement to require the first party to select the goods it intends to purchase from a wider selection of goods available for export from the second party and to allow the first party to fulfill its purchase obligation within a

time period of up to three years after the execution of the agreements.²⁴ The goods purchased by the first party are usually not related to the products sold by the first party to the second party.

The quantity of goods to be purchased by the first party is generally designated in currency terms as a percentage of the contract price of the first obligation, and the "price" of the goods is often designated in the form of a pricing formula such as "the recognized international price for the commodity at the time of purchase." The dollar amount of goods purchased by the first party can be lower, equal to, or greater than the total price involved in the first obligation.

The goods to be counterpurchased are often of an inferior quality or not in great demand on the international markets. Consequently, a penalty clause is generally included in the second agreement which provides that if the first party fails to purchase the agreed-upon quantity of specified goods within the agreed-upon time period, it will be required to pay a percentage of the countertrade value or its unfilled portion.²⁵ The financing of each of the two agreements in the counterpurchase transaction is quite similar to that of the standard transnational trade transaction since the products in each instance will be exchanged for currency.

2. *The Importance of Separate Transactions.* The key to understanding the counterpurchase transaction is to understand the importance of the two "linked but separate" commercial undertakings. As stated above, the two agreements must be linked in order to provide the incentive for the first party to agree to counterpurchase the less desirable goods of the second party. (The second party will look to "lock" the first party into the otherwise undesirable position of agreeing to buy less desirable goods subject to a guaranteed penalty clause through the incentive of consummating the first portion of the transaction). Care must be taken, however, not to allow the two agreements to become so closely entwined that they "merge" into one obligation. This is undesirable for a number of reasons. To begin with, a bank which would normally be interested in financing the conventional portion of the transaction (the first agreement) will most likely opt not to do so if the second agreement is legally connected to the first. The bank will generally

24. As an example, the first party will agree to sell to the second party specified mining equipment for the price of \$1 million, and will agree to purchase from the second party \$1 million worth of either electrical components, hand tools or finished electrical products within three years from the purchase date of the mining equipment. The first party will have the option of selecting which of the three types of goods (or combination thereof) it will purchase in order to fulfill its obligation.

25. A penalty of ten to twenty percent of the second obligation is not uncommon.

insist that the first agreement be completely free of any conditions or requirements related to counterpurchase and look at the borrower (the second party) based upon its independent ability to repay the borrowed funds. Banks are often not willing to take the risk of extending credit to a purchaser whose ability to repay the loan is dependent upon a variable such as the expected income from a counterpurchase transaction.

Similarly, export risk guarantees from such institutions as the United States Export-Import Bank ("Eximbank") are much simpler to obtain if the transaction is free from such variables. Counterpurchase obligations are often viewed as awkward and risky complications upon which a guarantor is not willing to depend.

A third reason for the separation of the contracts is that the first agreement will be allowed to mature independently of the second. The first sale can be undertaken and paid for with all parties satisfied, and if problems arise with the second sale, the first transaction would not be encumbered.

Counterpurchase Contracts

The "contract" in a counterpurchase transaction generally consists of three separate components: two purchase agreements and a protocol. Each of these three components has a separate legal significance independent of the other two, but when joined together, form one integrated legal instrument embodying all of the interlocking components of the counterpurchase transaction. Generally, the components are negotiated and executed simultaneously or in the order set forth below.

The following is a list of suggested provisions to be included in a counterpurchase contract, setting forth the three major components of the contract as well as the various subordinate provisions under each of the three main headings. It should be recognized that this list is not intended to serve as a rigid model for contract drafting but rather as a flexible starting point from which the businessman and his attorney can begin their work in negotiating and consummating a satisfactory counterpurchase transaction.²⁶ Due to space limitations, only those contract clauses which have unique significance in the counterpurchase transaction will be discussed in detail.

26. In addition, since the parties to the contract will most likely be from different countries, it is advisable that "local" counsel familiar with the laws of the non-U.S. party be consulted in order to determine the legality and effectiveness of the contract under the laws of the country of the other party.

Counterpurchase Contract

1. *Protocol*
2. *Primary Sales Agreement*
 - parties
 - recitals
 - acknowledgement of obligation to purchase goods
 - description of goods, specifications
 - quantity
 - price, terms of payment
 - method of payment, guarantee thereof
 - time, terms and other details regarding delivery
 - packing
 - shipping
 - insurance
 - documents, documentary transfer
 - guarantee of quality, quality control
 - right to inspect
 - right to neutral surveyor
 - determination and settlement of claims
 - penalties, remedies (or other agreed upon arrangements)
 - in the event of:
 - late delivery
 - delivery of non-conforming goods
 - failure to deliver
 - force majeure
 - arbitration
 - choice of law
3. *Secondary Sales Agreement*
 - parties
 - recitals
 - acknowledgment of obligation to counterpurchase goods
 - list of available goods
 - specifications, description, quality
 - quantity of counterpurchase
 - price, terms of payment, guarantee thereof
 - time period in which to fulfill obligation
 - terms and other details regarding delivery
 - linkage
 - marketing restrictions
 - packing
 - shipping

insurance
documents, documentary transfer
guarantee of quality, quality control
right to inspect
right to neutral surveyor
determination and settlement of claims
first party penalties, remedies
second party penalties, remedies
cancellation of first sales agreement
transferability of counterpurchase agreement
force majeure
arbitration
choice of law

1. *Protocol.* As discussed above, the "link" between the two subordinate sales agreements is generally created through the use of a protocol or preliminary statement that the parties agree to enter into both subordinate agreements simultaneously. The protocol should be looked upon as a contract in itself, separate from the two underlying purchase agreements, which is fulfilled upon the parties' execution of both underlying sales agreements.

2. *Primary Sales Agreement.* The agreement for the primary sale of goods from the first party to the second party is generally a standard contract for the sale of goods used in a conventional international trade transaction. One point of particular importance, however, should be recognized. It is critical that no reference should be made in the primary contract to the obligation of the first party to purchase goods from the second party under the second contract. References should especially be avoided which acknowledge that the obligation under the second contract is part of the consideration paid by the first party in connection with the first obligation, or which in any other way describes the second obligation as part of the "bargain" involved in the first agreement. To do so would cause the two agreements to "merge" into one obligation, thus initiating all of the problems involving financing, guarantees and execution discussed *supra*.

3. *Secondary Sales Agreement.* The second agreement, where the first party agrees to purchase the goods of the second party, should include the following provisions:

- a.) *Recitals.* The parties may wish to use the recital portion of the second agreement as an opportunity to tie the second agreement into the first agreement in lieu of a protocol. As stated above, however, care must be used to prevent the merger of the two separate agreements into one integrated obligation.

- b.) *Acknowledgment of Purchase Obligation.* The first party acknowledges its obligation to purchase certain products from the second party in consideration for the purchase price to be specified either in the agreement or at a later date.
- c.) *Time Period.* The parties designate a period of time in which the first party is allowed to fulfill its counterpurchase obligation. A time period of one to three years is common. Obviously, the greater the time period which is available, the greater the advantage to the first party.
- d.) *List of Available Goods.* As is the case with the time period, the greater the flexibility afforded in the selection of goods to be purchased, the greater the benefits available to the first party in connection with the subsequent resale of the purchased goods. The specific parameters within which the first party can operate in selecting its counterpurchase goods depend upon the sophistication of its position in the international markets, either via its own sales network or through its contacts with outside trading companies. In most cases, the most undesirable counterpurchase goods are finished products, while the most desirable goods include raw or semiprocessed materials, ores, chemicals and other easily traded goods.
- e.) *Quality of Counterpurchase Goods.* Due to the nature of many counterpurchase goods, *i.e.*, being of inferior quality or in low demand, it is essential that quality control provisions be established which set forth detailed specifications for acceptable goods and which either (a) state that goods will not be accepted unless meeting the agreed upon specifications, or (b) set forth contingent arrangements or options for the first party in the event that the goods fail to conform to the agreed upon specifications (*e.g.*, reduction in price, alteration of purchase requirement, etc.)
- f.) *Quantity of Purchase.* The quantity of goods to be counterpurchased should be designated. This can be accomplished either through the designation of an exact quantity of specified items or in a dollar amount as a percentage of the first sales agreement.
- g.) *Price.* If the quantity and description of the goods and exact date of sale have been definitively set in the second agreement, a prearranged selling price will most likely be established and included in the contract. In the event that the goods to be purchased will be selected by the first party at a future date, a "pricing formula" will most likely be included in the agreement in lieu of a firm price. For example, price provisions such as "the acceptable international price at time of purchase" or "five percent below the

fair market value of the goods in the first party's home country" are common. In the event that a pricing formula is to be utilized for the future selection of prices, it is most likely in the interest of both parties that the formula be carefully structured, extremely specific and accurately articulated. (Occasionally it is determined by a party that due to market volatility or other external conditions, it may be in its best interest to enter into an agreement with ambiguous pricing provisions.)

- h.) *Right to Inspect, Right to Neutral Surveyor.* It is clearly in the interest of the first party to obtain the right to inspect the counterpurchase goods. It is preferable for the first party to have the right to reject the goods in the event that it determines that the goods do not conform to the contract specifications. An alternative arrangement is to provide for the selection of a neutral surveyor, selected by both parties, to render a binding decision concerning the quality of the goods in question.
- i.) *First Party Penalties.* The second party will most likely insist that a penalty provision be included which provides that in the event the first party fails to fulfill its counterpurchase obligations in full, a penalty be paid by the first party. A penalty of from ten to twenty percent of the value of the countertrade goods or the unfulfilled portion of the second agreement is common. It should be specified, however, that payment of a penalty by the first party does not affect the obligations of the parties under the first agreement. Additionally, the first party should be assured that once the penalty is paid, all of its obligations under the second agreement shall terminate. It should be recognized that this provision may be used by the first party as an "escape clause" in the event that it is no longer willing or able to fulfill its obligation under the second agreement and should be negotiated in anticipation of the possibility of such an occurrence. While the first party would prefer not to be required to obtain a bank guarantee for the penalty clause, such a request by the second party is common and frequently agreed to by the first party.
- j.) *Second Party Penalties.* A penalty provision should also be included for the benefit of the first party in the event that the second party fails to perform as agreed. The second party would fail to perform through its failure to provide the contract goods, its tendering of inferior goods, or through the late delivery of the otherwise conforming goods. One option would be to impose a financial penalty upon the second party in proportion to the degree of severity of its failure to perform, e.g., a minor variation in quality

would result in a slight reduction in contract price, while a significant variation would result in a substantial price reduction. Another option would be for the obligation of the first party under the second agreement to be void or voidable, *i.e.*, its obligation to purchase goods from the second party is eliminated or it obtains the option of withdrawing from the second agreement. Once again, it should be specified that the imposition of any penalties would not affect the rights of either of the parties under the first agreement.

- k.) *Cancellation of First Agreement.* It should be agreed between the parties that in the event that the first agreement is cancelled, the second agreement is void or voidable at the option of the first party.
- l.) *Linkage.* In the event that the second party is a communist country or other country with a variety of governmental offices responsible for the sale and control of different commodities, the first party may wish to be guaranteed the opportunity to purchase certain commodities from branches of the government other than the one with which it is entering the agreement. This concept is known as "linkage." Obviously, this is beneficial to the first party, since it broadens its options in connection with the goods available for counterpurchase.
- m.) *Transferability of Second Agreement.* It is greatly to the advantage of the first party to have the option to transfer its rights and obligations under the second agreement to a trading house or export trading company which may be better equipped to market the counterpurchase goods. A clause should be included which would specifically provide the first party the right to transfer its interest under the second agreement to another party. In the event that the second party requires that this be allowed only with its permission, it should be agreed that this permission will not be unreasonably withheld.
- n.) *Marketing Restrictions.* The first party should obtain the consent of the second party to market the counterpurchase goods free of any interference or other restrictions from the second party. This would include restrictions on geographic areas of marketing and on potential purchasers.
- o.) *Dispute Settlement.* It is essential to specify in the agreement the mechanism which is to be utilized in the event a dispute arises in the course of performance under the agreement. Due to the transnational nature of the transaction, conventional litigation is often an awkward, expensive and unreliable means of dispute settlement. A viable alternative is for the parties to consent mutually to binding arbitration. A common arrangement is to agree

that arbitration will be conducted in the home country of the party complained against, utilizing three arbitrators: one selected by each of the two parties and the third selected by the first two arbitrators. A second option is to designate a prearranged arbitrating body such as the International Chamber of Commerce or the Stockholm Chamber of Commerce, a prearranged third country of arbitration, and a set of arbitration rules such as the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules. Western firms often prefer "neutral" nations such as Switzerland, Sweden, or Austria as a forum country. If a choice of law is to be agreed upon, a codified legal system is generally preferred over a case law system such as that utilized in the United States.

- p.) *Force Majeure*. A clause should be included which provides that the seller shall not be held responsible for the delay or non-delivery of the goods due to *force majeure*. It is advisable to specify the events which would constitute *force majeure* (communist governments will most likely reject the term "acts of God" since God is not recognized, although "acts of nature" can be substituted therefor).

IV. THE BARTER TRANSACTIONS

Mechanics of the Barter Transaction

On its face, the barter transaction appears to be relatively uncomplicated; however, a closer look reveals a number of potentially difficult areas which must be taken into consideration in order to be assured of a safe and orderly transaction.

Under a conventional trade transaction (utilizing the customary documentary transfer and letter of credit), the letter of credit provides the source of security to both parties: first, to the seller in the form of a guarantee of payment, and second, to the purchaser in the form of a guarantee that funds will not be released until the goods are found to be satisfactory to the issuing bank. Once the "currency" portion of the transaction is eliminated as a result of a barter requirement, the security provided by the letter of credit is no longer present.

A way to avoid this pitfall is to undertake the normal transfer of documents (bills of lading, etc.) for each of the sets of goods being bartered in conjunction with a set of non-currency or "standby" bank guarantees. Under such an arrangement, the first party requests that the second party's bank issue a standby letter of credit, providing, in essence, that in the event the second party fails to meet its obligation under the barter contract (*i.e.*, fails to

ship the designated goods to the first party), the first party would be entitled to draw payment in hard currency for the goods under the standby letter of credit. Upon issuance of the letter of credit by the second party bank, the first party would have the letter of credit confirmed by its own bank in its home country.²⁷ Of course, the second party would seek the same form of guarantee from its own bank for its own benefit. Another arrangement is to establish an evidence account at a neutral bank where equal credits are made to each party upon delivery. If the transaction proceeds as expected, the crediting of each party's account will occur simultaneously and cancel each other out. The parties will be left with their respective delivered products, having provided guarantees of security in case of default.

The Barter Contract

The barter transaction requires the use of one contract as compared to the use of multiple contracts in the countertrade transaction. As one may expect, a barter contract includes most of the standard provisions contained in a conventional transnational trade contract, with the addition of a number of special provisions to effectuate the barter arrangement. The conventional contract is adapted through the elimination of the normal provisions concerning price and currency payments and by the substitution of provisions regarding description and delivery of the second product to be bartered. In addition, the contract should clearly and accurately set forth provisions concerning penalties, "escape clauses" and other "contingency clauses" and the accompanying bank guarantees, as the situation may dictate.²⁸

1. *Special Attention to Contingencies.* When all of the details are stripped away, the ordinary contract for the cash sale of goods contains two basic elements — provisions regarding the goods to be provided and the purchase price to be paid. Of these two, the first generally provides the greatest degree of difficulty for the parties due to the innumerable variables

27. In the event that the first party would find it difficult to have the second party letter of credit confirmed, such as is the case in transactions with the People's Republic of China, an alternative form of guarantee is also available. Here, the first party would request that the second party's bank issue a performance bond, similar in substance to the standby letter of credit discussed above, which would subsequently be guaranteed by the first party's bank. In the case of a U.S. first party with a U.S. bank, since U.S. banks are not permitted by law to issue "guarantees," a foreign (*e. g.*, Hong Kong) branch of the U.S. bank would issue the guarantee required to secure the performance bond of the second party. Once again, the same form of protection could be established in favor of the second party by simply reversing the above process in favor of the second party.

28. See Barter Contract Checklist, *infra* at 215-16.

associated with the production, packaging, shipping, and delivery of the commodity in the quantity and time frame designated. In the conventional transaction, the experienced businessman anticipates these difficulties and provides for a broad variety of specific contingent arrangements in the contract (arbitration, *force majeure*, penalties, etc.) in order to avoid the subsequent breakdown of the transaction. It must be emphasized that in a barter transaction, the chances of full or partial default occurring, are almost twice as great as in a conventional transaction, due to the presence of two sets of goods and two sets of the above-stated variables. Consequently, the draftsman of the barter contract should be especially attentive to anticipating the problems connected with the quality and delivery of both sets of goods and insist upon the inclusion of a full range of quality control and contingency clauses in the barter contract. This would include, *inter alia*, provisions covering the following:

- detailed specifications and description of goods
- guarantee of quality and quality control
- right of inspection
- right to neutral surveyor
- determination and settlement of claims penalties:
 - late delivery
 - delivery of non-conforming goods
 - failure to deliver
- force majeure*
- arbitration
- choice of law
- bank guarantees

2. *Escape Clause.* A contingency clause worthy of special consideration in the context of the barter transaction is an "escape clause" to be exercised in the event that one of the parties fails to perform satisfactorily under the agreement. In essence, the escape clause provides that in the event one party is determined (through arbitration or other means as provided in the contract) to have substantially breached its portion of the obligation, the non-breaching party has the option to be paid immediately a pre-agreed price in currency in lieu of being forced to wait for delivery of the bartered product.²⁹ In addition, the clause should provide that if the breaching party is later in a position to perform, *i.e.*, to deliver the conformed product, the non-breaching party would be under no obligation to purchase the delivered items.

29. This clause can be drafted in conjunction with the bank guarantee clause discussed *supra* at pp. 212-13.

The following is a list of suggested provisions to be included in a barter contract, setting forth the major provisions to be utilized in formalizing the barter transaction, including the contingency and guarantee clauses discussed above. Once again, it should be noted that since no two transactions are identical (especially in the barter context), this list is not intended to serve as a rigid model but rather as a flexible framework and starting point for the preparation of the contract document.

Barter Contract Checklist

parties

recitals

acknowledgement of obligation of first party to provide and accept goods

acknowledgement of obligation of second party to provide and accept

goods

first party goods

- description of goods, specifications
- quantity
- time, terms and other details regarding delivery
- packing
- shipping
- insurance
- documents, documentary transfer

second party goods

- description of goods, specifications
- quantity
- time, terms and other details regarding delivery
- packing
- shipping
- insurance
- documents, documentary transfer

bank guarantees providing for full payment in the event of the non-performance of one party

guarantee of quality, quality control

right to inspect

right to neutral surveyor

determination and settlement of claims

penalties (or other agreed upon arrangements) in the event of:

- late delivery
- delivery of non-conforming goods
- failure to deliver

force majeure
arbitration
choice of law

V. COMPENSATION TRANSACTION

Mechanics of the Compensation Transaction

As discussed above, the compensation transaction consists of a pair of agreements wherein the first party undertakes to sell equipment, machinery, technology and/or an entire turnkey manufacturing facility ("equipment/technology") to the second party and agrees to purchase a certain predetermined quantity of the goods produced by the equipment/technology from the second party. Generally, compensation transactions are considerably more complex than the straightforward counterpurchase transaction due to the greater number of variables involved in the establishment of a full-scale overseas manufacturing facility. Not surprisingly, there are often much greater amounts of money involved and the period of repurchase is frequently much longer than under the counterpurchase agreement (generally five to ten years) as a result of, *inter alia*, the start-up time involved in the planning, construction and training activities related to the project.

As with the counterpurchase transaction, the compensation form of countertrade involves two separate agreements linked by a protocol. The reasons for the structuring of the transaction in this way are the same as in the counterpurchase transaction. However, this form of structuring is especially necessary in compensation transactions, due to the desire to keep large front-end payment obligations for the equipment/technology separate from the innumerable variables involved in the establishment and commencement of the manufacturing activity. In addition, the first party will most likely wish to keep the contracts "linked" to insure that the goods it will be purchasing will be produced from its own equipment/technology instead of from a less desirable foreign substitute.

Compensation Contracts

The compensation contract is very similar in format to the counterpurchase contract, including the use of the three major components: the two purchase agreements and the protocol. Attention should be drawn, however, to the first agreement, *i.e.*, the one dealing with the sale of the equipment technology. Unlike the conventional international trade agreement as utilized in the counterpurchase transaction, the contract for the transfer of equipment and technology is anything but "standard", and a large number of opportunities exist for difficulties to arise. The first party is advised to pay special attention to the terms of the agreement in conveying its equipment/

technology in order to protect its technologically competitive position in the international market place and to avoid future disputes throughout the course of the cooperative effort with the second party.

The following is a list of the major provisions contained in a compensation contract, once again provided as a flexible framework and starting point rather than as a rigid drafting model.

Compensation Contract

1. *Protocol*
2. *Primary Sales Agreement*
 - parties
 - recitals
 - acknowledgment of obligation to purchase equipment/technology
 - description of equipment/technology, specifications
 - price, terms of payment
 - method of payment, guarantee thereof
 - time, terms and other details regarding delivery
 - additional provisions related to specific aspects of agreement such as performance of equipment/technology, use, improvements upon and transfer of technology, roles played by employees, consultants and technical advisors, and overall operation of equipment/technology
 - packing
 - shipping
 - insurance
 - documents, documentary transfer
 - guarantee of quality, quality control
 - right to inspect
 - right to neutral surveyor
 - determination and settlement of claims
 - penalties (or other agreed upon arrangements) in the event of:
 - late delivery
 - delivery of non-conforming goods
 - failure to deliver
 - force majeure
 - arbitration
 - choice of law
3. *Secondary Sales Agreement*
 - parties
 - recitals
 - acknowledgment of obligation to counterpurchase goods

list of available goods
specifications, description, quality
quantity of counterpurchase
price, terms of payment, guarantee thereof
time period in which to fulfill obligation
terms and other details regarding delivery
linkage
marketing restrictions
packing
shipping
insurance
documents, documentary transfer
guarantee of quality, quality control
right to inspect
right to neutral surveyor
determination and settlement of claims
first party penalties, remedies
second party penalties, remedies
cancellation of first sales agreement
transferability of counterpurchase agreement
force majeure
arbitration
choice of law

1. *Protocol.* As with the counterpurchase transaction, the two underlying agreements should be linked as a result of the two parties agreeing to enter into both of the subordinate contracts simultaneously. Once again, this is accomplished through the use of a protocol.

2. *Primary Sales Agreement.* Emphasis should be placed upon a thorough anticipation of all the aspects of the sale of the equipment/technology and upon clear and precise definition of all the rights and obligations of the parties connected thereto, including the rights and obligations involved in the delivery and performance of equipment and machinery, the use and transfer of technology and the roles played by any employees, consultants and technical advisors provided by the first party.³⁰ Special attention should be devoted to specifying and limiting the extent of

30. For an excellent discussion of compensation contracts, see James W. Schroeder, "Some Legal Considerations in Joint Venture and Countertrade Arrangements in U.S.-China Trade," presented before the American Management Association, June 20, 1980. See also "Selling Technology to China," National Council for U.S. — China Trade, 1979.

the first party's rights and obligations related to manpower assistance, performance guarantees, and the secrecy of improvements upon, and transfers of technology and know-how.

Payment should be called for in hard currency at the time of the transfer of the technology or in time increments as the manufacturing facility is transported and constructed in the host country. Once again, if goods produced from the factory are designated to be used as payment for the purchase of equipment and technology, the result will be a "merged" barter-type transaction, and the parties may experience difficulty in obtaining adequate financing and risk guarantees.

3. *Secondary (Compensation) Sales Agreement.* The second sales agreement in the compensation transaction is generally a counterpurchase agreement similar to that utilized in the second agreement in the counterpurchase transaction discussed in Part III above. The major differences one may encounter between the second compensation agreement and the second counterpurchase agreement is that in the compensation transaction the goods to be purchased by the first party will most likely be specified (*i.e.*, those produced from the plant in question) and the length of the counterpurchase period will be considerably greater. Special attention should be paid to the following clauses because of the broad degree of variables inherent in the compensation transaction:

- a) specifications regarding acceptable goods, quality control (it is common for local skilled-labor problems to result in poor workmanship and low quality goods);
- b) price, terms of payment;
- c) marketing restrictions; and
- d) dispute settlement, arbitration and choice of law.

VI. CONCLUSION

Although not a predominant form of transnational commercial dealing, barter and countertrade are coming into greater prominence in Third World trade transactions in response to ever-changing conditions in the international economic and political environment. Hard currency shortages, dramatic changes in the world energy situation and ever present pressures to reduce trade deficits have created a need for the innovative structuring and financing of international trade transactions. Unlike the case with many of the more conventional forms of international trade, however, barter and countertrade are characterized by uncertainty and risk due to their heretofore limited use, and businessmen confronted with the opportunity of engaging in the same, face the task of exploring new ground in the intricate world of transnational business dealings. The result of these developments is

that international businessmen and their attorneys have the freedom to be more creative and responsive in their business activities, but are forced to be more thorough and alert in structuring and memorializing their new form of trade undertaking.