Chapter 7 CONTRACTS, CONTRACTUAL ISSUES AND FINANCIAL MECHANISMS

7.1. Introduction

As a part of any conventional trade agreement it is usually necessary to produce a contract, outlining volumes of products, price, delivery period and so on. Normally such contracts are limited to one document, such as a sale and purchase contract.

In the case of reciprocal trade arrangements the number of contracts can vary tremendously, from one, up to any number, depending on the type of deal and the number of parties involved in the total transaction. The potential problems and time involved in negotiating and drawing up these contracts can be quite considerable and can add to the cost of the transaction as a result. It is in the interest of all parties to ensure that the terms of the deal are laid down in the various contracts in order to facilitate the efficient operation and completion of the deal. Therefore it is of great importance to produce contracts that are clear and concise. Expert advice and assistance from external sources may be required, (refer to Chapter 9).

7.2. Forms of Contract for Different Types of Deal

The contract requirements depend largely on the nature of the proposed deal. The wide range of countertrade transactions that exist (see Chapter 3) create a need for varying forms of contracts. In this section we deal with various basic models of countertrade such as barter, counterpurchase and buy-back, each of which necessitates very different contractual forms. There are also a vast number of other deals that do not fit neatly into any of these categories but may include some common elements. This is true, for example, of some of the state trading agreements. In the following sub-sections we make some generalisations (there are no rules) about forms of contract for barter and counterpurchase and similar deals. A separate section on buy-back contracts is provided in section 7.5.

The forms of contract for barter range from fairly broad agreements at government level to concisely worded documents outlining the exact terms of a transaction. In many cases there may be a broad agreement at government level which lays open opportunities for parties within each country to trade with one another. Under such circumstances, the only documentation for the trading part of the barter may consist of a series of telexes between the trading partners, often using an escrow account. As a result, no simple model or format exists for barter contracts. However, where there is a formal contractual arrangement, it can often be contained in a single contract.

State Trading Arrangements between governments, parastatal organisations and/or foreign trading houses are also based on a single contractual agreement, normally drawn up by the developing country government. An example of such an agreement can be found in Appendix 2.

Buy-back arrangements and counterpurchase deals often require the use of more than one contract between the principal parties, either because there are more than two principals, or to provide specifications for separate contractual elements.

7.3. Single and Multiple Contracts

There are advantages and disadvantages in using either single or multiple contracts, depending on the type of deal and the parties involved. There is no value in complicating proceedings by using multiple contracts when a single one will do.

Many foreign partners, particularly those inexperienced in countertrade, or those wishing to assign obligations to third parties, may insist upon a more formalised approach which will reduce the risk of failure, non-performance or non-payment. In such cases it is usual for two sale and purchase contracts to be concluded by the principals. These determine the conditions of the trade flows. Normally a third countertrade contract forms the basis of a linkage between the two sale and purchase contracts.

There are a number of reasons why foreign partners may wish to use multiple contracts.

- Export credit guarantee facilities from organisations such as ECGD in the UK may only be available if contracts are separated.
- Failure to fulfil one element of the transaction does not necessarily nullify the original export contract.
- Alterations in contractual terms can be more easily incorporated.

Multiple contracts may consist of:-

i) a sale and purchase contract for the imported goods
ii) a linkage or framework contract
iii) sale and purchase contract/s for the exported goods.

i) Sale and Purchase Contract for the Imported Goods
This contract contains the details of the specific performance of the foreign supplier, including the nature and value of goods and/or services, delivery, etc. and the corresponding payment terms by the recipient, usually quoted in foreign exchange.

ii) Linkage Contract
This contract is between the two signatories to the sales contract and concerns balancing, in whole or in part, the trade flows.

The document may be very specific in its terms and commitments or it may take the form of a non-binding "letter of intent", where the first party offers its "best efforts" to purchase goods on a countertrade basis. Generally the specific approach is adopted, as this provides a more rigid framework which determines the actual percentage of the original sales contract that should be reciprocal.

iii)Other Sale and Purchase Contracts for the Exported Goods

These are the one or more sale and purchase contracts which are concerned with the discharge of the counterpurchase obligation.

7.4. The Content of Contracts

This sub-section deals with major contractual issues, some of which are common to all forms of countertrade, while others are specific to particular types. Emphasis is placed on those parts of contracts which deal with the reciprocal trade aspects; in other words, in the case of counterpurchase, with the linkage contract rather than the sale and purchase contracts. For the sake of clarity we have described many of the issues in terms of a counterpurchase transaction, but many of these issues are equally applicable to barter-style and various other forms of countertrade. Points (i) - (xiii) below describe many of the elements to be included in a countertrade contract but the list is by no means exhaustive and simply provides a set of indicators. Some examples of contracts are provided in Appendix 2.

(i) Commitment to countertrade by two principals.
(ii) Assignment to third parties.
(iii) Proportion of countertrade.
(iv) Products available for countertrade.
(v) Verification of allowable exports.
(vi) Product specifications.
(vii) Price of countertrade products.
(viii) Resale of countertraded exports.
(ix) Payment terms and conditions.
(x) Timing.
(xi) Monitoring trade flows.
(xii) Penalties.
(xiii) Arbitration and force majeure.

N.B. The terms "import" and "export" are used from the perspective of the developing country.

(i) Commitment to Countertrade

Once countertrade has been accepted in principle by both parties and has approval to proceed, the countertrade contract should contain, in its early stages, a clear commitment by the foreign partner to purchase the products specified in the contract.

(ii) Assignment to Third Parties

Under certain circumstances, for example, if the foreign partner is either unable to absorb the goods in-house or does not have the relevant expertise to sell them, and with the agreement of the two principal parties, it is common practice to assign the counterpurchase responsibility to a third party, normally a trading house.

If all or part of the countertrade products are to be handled by a third party, there should be a clause within the contract to this effect. If, on the other hand, no third party involvement is allowed, this should be stipulated.

If assignment is agreed, there should also be some indication of the obligations of the foreign partner with respect to fulfilment of the counterpurchase. For example, it may be that all obligations are transferred to the assignee; conversely, they may remain the total responsibility of the foreign partner. Sometimes both parties are obliged to share responsibility for fulfilment of countertrade obligations. The contract should make it clear whether the developing country partner has recourse to the foreign partner, the assignee, or both.

It is important that the counterpurchase contract should include a clause committing the assignee to be bound by its provisions with regard to the assigned portion of the counterpurchases. Failure to obtain such a commitment could lead to non-fulfilment of the contract, or to the sale of countertrade products to markets specifically excluded in the contract.

(iii) Proportion of Countertrade

The countertrade contract must contain some definition of the value of the countertrade commitment. There are two ways in which this may be achieved. The first is to specify the actual countertrade value in monetary terms. This may be less than, equivalent to, or more than the value of the original purchases. The alternative is to specify the level of counterpurchases as a percentage of the value of the goods sold through the original sales contract. The latter may be used when the final price of the imported goods has not been settled.

In either case, the form of payment should also be stipulated. If the values specified are in local currencies, agreement on an exchange rate should be written into the contract.

When the countertrade obligation is expressed as a percentage of the original purchase value, there should be no ambiguity regarding the original price of the imported product/s.

(iv) Products Available for Countertrade

A countertrade contract should indicate the products available for export from the developing country. This may be expressed in the form of particular product/s (with quantities and/or values specified) or as a range of products from which a particular selection may be made. As a variant on the latter, ceiling values may be attached to each of the products listed (this approach is adopted in the STA presented in Appendix 2).

An alternative method is to specify the source of the products, as in the following cases:

- any products produced by the importing agency (whether private sector, parastatal or otherwise)
- any products produced by the importing agency or its subsidiaries
- any products that come within the auspices of a specific ministry (ministries) or other authority (authorities)
- products from mixed sources as specified, e.g. percentage from importer and percentage from other specific sources.

A further alternative approach is to specify products which are not allowed. For example, it may be possible to export all products except those quoted on commodity exchanges.

It is often wise to include a disclaimer such as: "subject to the approval of the competent exporter and relevant ministry". This then puts the onus of product procurement on to the foreign partner or assignee and reduces arguments regarding non-delivery of products between the principal parties.

The foreign partner may insist upon a greater commitment by its developing country partner to procure products for countertrade, particularly when there are likely to be product shortages. Under such circumstances, the contract should specify the degree of involvement of the developing country party. The level of such a commitment will probably fall between the following two extremes:

- the developing country partner guaranteeing that the products specified will be available at the time of performance
- the developing country partner offering assistance on a best efforts basis to help with product procurement.

Depending on the regulations within each country, specific authorisation from relevant government bodies may be required for specific products to be used in countertrade. In such cases a clause describing these conditions and/or restrictions, and which party shall be responsible for seeking authorisation, should be included in the countertrade contract.

(v) Verification of Allowable Exports

It should be made clear which products exported by the foreign partner are regarded as contributing to his countertrade obligations. This is particularly true of partners that have traditionally traded with the developing country in question. As a means of verifying their countertrade obligations, most partners will insist that each purchase contract entered into within the framework of the countertrade contract is recognised. Consequently, they may insist that the countertrade contract stipulates that each purchase contract must explicitly refer to the countertrade contract. In this way, purchases can be easily monitored and accounted against the countertrade obligation.

(vi) Product Specification

It is in the interest of all parties that the products traded are of the specifications laid down in the purchase and sales contracts in terms of quality and quantity. It is often advisable to include a clause in the countertrade contract reinforcing this issue by stating that the products must conform to the standards specified in the individual purchase and sale contracts. This can be particularly advantageous for the foreign partner who assigns his obligation to a third party.

(vii) The Price of the Products

It is usual for prices in countertrade contracts to be expressed in terms of prices prevailing at the time the contract is activated rather than in absolute terms. For example, the price of raw materials or commodities may be fixed according to the price at the time of shipment on a specified commodity market, or reference may be made to prices for similar products in the export market destination.

Where only the two principals are involved, i.e. no third party assignees are to be employed, the prices may be stipulated in the countertrade contract. Where a third party assignee is concerned it is unlikely that the assignee will agree to such terms, and will insist on some involvement in price negotiations.

The parties should agree in the countertrade contract on the currency in which the countertraded products should be quoted and paid.

In cases where the prices of countertrade products are volatile or, perhaps, where the deal is operative over a long period, an agreement to employ price arbitration may be included in the contract.

Price-cutting in order to make countertrade products more attractive can be dangerous. Not only does this practice make the products imported through countertrade appear expensive, but there have been accusations of dumping in some cases, where products which were traditionally difficult to sell have been exported via countertrade at a discount, causing disruption in the target markets.

(viii) Resale of Countertraded Exports

If the developing country wishes to prohibit the resale of its exports to third countries, this must be explicitly stated in the contract. In other cases, resale may be permitted in certain circumstances which should be specified, or, alternatively, any particular restrictions on resale may be included.

(ix) Payment Terms and Conditions

The types of payment terms and conditions which may be appropriate include:-

- how and against what documents payment will be effected,
- whether letters of credit or other documentation will have to be arranged by the buyers,
- which parties will be responsible for the costs involved in the payment arrangements,
- agreement on an escrow or trust account arrangement.

(x) Timing

Establishment of a time frame within which the foreign partner should fulfil his obligations will be based upon factors such as the size of the deal; the time required to procure the product(s); the time required to obtain government approval and documentation; and the time required for arranging financing.

The start date for fulfilment of the countertrade may be stipulated in the contract. In the case of large deals it may be appropriate to execute obligations in stages. For example, a specific percentage of the total value of the countertrade deal may be completed over a twelve month period, with the remainder to be concluded in stages within a specified period. In such cases, "completion" may have to be defined specifically within the countertrade contract. It could mean that goods to the value of the countertrade element have been ordered or even procured, or it could mean that they have been procured and paid for. Partners may be unwilling to accept a clause of fulfilment that stipulates that payment has to be made within a specified time period, as factors outside their control could cause delays in the procurement processes.

(xi) Monitoring Trade Flows

Methods of monitoring trade flows within countertrade deals can vary tremendously, from simple book entries to more formalised approaches. An evidence account (as described in section 7.6.4) is a simple technique for recording each side's performance under the terms of the contract.

Another possible method is to establish a committee made up of equal numbers of representatives from each side, whose role is to supervise the execution of the contract and alterations, if any, to the contract terms.

(xii) Penalties

Penalty clauses are quite a common feature of counterpurchase contracts (except in those cases where the countertrade obligation is described in terms of a "best efforts" basis).

Penalties should be set out in the contract and are usually expressed in the form of a percentage, for example, 25 per cent, of the unfulfilled part of the counterpurchase commitment. Rates of penalty may vary from a few per cent to 100 per cent or more.

Should non-compliance of the contractual terms be a result of a failure by the penalty-imposing party to fulfil its obligations, then it has no basis for a claim under normal contract law procedures. Eventualities that may release the foreign partner from his commitments include, for example, failure by the developing country agent to procure products as agreed in the contract.

In some cases, a bank guarantee is requested by the developing country party to assure the payment of a penalty. In this case the countertrade contract should specify the amount and type of the bank guarantee and the bank from which it should be obtained.

In most cases, payment of a penalty would be regarded as releasing the foreign partner from his contractual obligations and most countertrade partners are likely to insist that the contract specifies this. However, this might not be the intention of the developing country.

(xiii) Arbitration and Force Majeure

In the event of a dispute between the principal parties over any aspect of contract fulfilment, it may be necessary to resort to arbitration. This is a common practice in international trade in cases where a dispute cannot reasonably be settled by the contract signatories.

The arbitration board may be made up of a committeee approved by both parties, although reaching agreement on committee composition and on which national laws to use may cause problems. The alternative is to use a recognised arbitrator such as the International Chamber of Commerce or, if one of the parties is a government department, the International Board of Arbitration. A standard clause to this effect should be included in the contract.

e.g. "All controversies arising from the present contract shall be irrevocably settled in accordance with the regulations of the Board of Conciliation and Arbitration of the International Chamber of Commerce by one or more arbitrators nominated in accordance with the said regulations."

Whichever form of arbitration is agreed, it may be necessary to stipulate the place of arbitration, the composition of the committee and/or number of arbitrators, and the commercial laws that are to be applied by the committee.

As in all international trade, the use of a clause of force majeure is likely to be insisted upon by the foreign partner to provide some protection against a range of potential difficulties. The actual wording of such a clause will depend upon the laws of the partner countries and should be negotiated prior to signing the contract.

7.5. Buy-back Contracts

The buy-back form of countertrade as defined in Chapter 3 is a special case. In many respects the procedures for a counterpurchase transaction are also relevant to buy-back. However, there are other complications, most of which relate to financing such deals. This can involve a number of parties such as commercial banks, export credit guarantee agencies, the World Bank and other suppliers of loan funds.

There are usually two principal trade contracts and one financing contract.

(i) The Supply Contract - covering supply of equipment, know-how and licences where necessary.
(ii) Credit Agreement - defining financing arrangements between importer's bank and supply consortia's bank.
(iii)The Buy-back Contract.

(i) The Supply Contract

The initial supply contract consists of details regarding technical aspects of the plant and processing machinery to be supplied, as well as outlining some of the commercial and financial aspects of the supply transaction. Signatories to this contract include:

- supplier of the plant
- other suppliers of equipment for the plant
- the licensor, if different from above
- the importer of the plant and equipment
- the importer of the licence, if different.

In general, the conditions applying to a supply contract within a buy-back deal are the same as those applying to a normal trade transaction.

(ii) Credit Agreement

The credit agreement will usually be of a conventional type. On occasions, aid funds may be involved. In practice, the World Bank and other similar organisations may be more reluctant to assist in financing countertrade linked projects. However, it may be emphasised by the recipient country that the project will not only lead to industrial development but is also backed by a guaranteed export market.

(iii) The Buy-back Contract

The buy-back contract is signed by the buyer of the resultant products and the organisation or agent exporting those products. These organisations may or may not be the original vendor and recipient of the plant and other inputs, but assignees acting on their behalf.

The key issues that any purchaser of buy-back products is likely to raise during negotiations and later stipulate within the contract are set out below.

- The quality of the resultant product and verification that the plant supplier's specifications and recommendations have been complied with.

- The restrictions, if any, on the final destination of the buy-back products.

- Arrangements for deciding prices and quantities exported (a partner may agree to purchase products up to a fixed value for the year, or a percentage of the total supply contract cost).

- Agreement on who pays shipping costs.

- Penalties to be imposed by the buyer if there are delays in the delivery of buy-back products.

- Other issues concerning quality control mechanisms for the buy-back products, clauses governing arbitration, force majeure and the commercial laws to be used in the contracts.

Within the buy-back contract the following details must be clearly stipulated:

- value of buy-back to be sold
- period over which transaction should be completed
- definition of where products can be marketed
- mechanism for pricing products and circumstances under which these may change
- penalties for poor quality products, delays or non-fulfilment of the obligation to supply.

7.6. Financial Aspects of Countertrade

In some instances, the financial aspects of countertrade deals are no different from orthodox export/import transactions. However, in many cases, due, for example, to the reciprocal nature of the trade, foreign exchange shortages, the reluctance of financial institutions to offer credit and insurance cover, or for other reasons, special arrangements are required.

Most financial arrangements have to be "tailor-made" for particular deals. When dealing with the more complicated transactions, it is of particular importance that specialist expert advice should be sought.

It is impossible to give guidelines that should be followed in all circumstances but the following sub-sections outline the most important financial mechanisms which are available for countertrade deals.

7.6.1. Bank Guarantee

Bank guarantees may be used as an assurance to countertrade partners that payment will be forthcoming. For example, a developing country exporter may obtain a letter of guarantee from his bank in favour of a supplier company. The letter of guarantee ensures that the supplier will be paid in cash for any outstanding imbalance at the end of the contractual time period. In this way, the supplier is paid in cash if the full value of the transaction has not been supplied in goods from the developing country. Initially, the letter of guarantee would be for the full value of the imported goods but it decreases as exports are shipped and documentary evidence of despatch is received by the bank. This technique can only be used when foreign exchange is available to back the letter of guarantee.

7.6.2. Escrow Account

Escrow accounts are used for the funds flow management of many countertrade deals and they offer specific guarantees to the parties to the escrow agreement. In order to provide the maximum security and protection against diversion of funds or other problems it is usual for the account to be held in a commercial bank in a hard currency country. The role of the bank is to administer the account and to ensure that it contains adequate funds to cover the trade transactions as they occur. It must be remembered that monies in an escrow account cannot be paid out for purposes other than those provided for in the escrow agreement.

There are no hard and fast rules, or even a comprehensive base, from which to start negotiations on establishing escrows. Each deal using these accounts is different, therefore each requires to be discussed and formulated according to the terms and nature of the countertrade deal.

When considering the use of escrows for countertrade there are generally three main considerations.

i) <u>The Need for the Escrow</u>

- Are alternative financial mechanisms available?
- Is it feasible to hold currency in off-shore accounts?
- Who will manage the account?

ii) <u>Who Will be Party to the Agreement?</u>

- Parties to the agreement will include the commercial bank holding the account, the supplier company and the importer in the developing country.

Others involved in the negotiations of the agreement may include:

- The Central Bank, particularly if exchange control regulations are in force limiting or prohibiting the holding of export revenues off-shore.
- The developing country exporter, if different from the importer.
- Any intermediary or third party traders.

In practice, the smaller the number of parties involved, the more likely is a successful outcome to negotiations.

iii) <u>Negotiations and Agreement Terms</u>

An escrow account is usually in the name of the developing country bank. The agreement should cover the rights and obligations of the various parties to the deal. The wording of such agreements is subject to negotiation and the facts relevant to each case. Initial negotations may be followed by discussion of draft or working papers which will later form the framework of the escrow agreement. The major issues covered normally include:

- Description of transaction.
- Description and mechanics of the financial flows.
- Mechanism for initial funding, i.e. from foreign exchange reserves or from revenue raised through exports.
- Percentage of the total transaction value that will be initially paid into the account, which will depend on the size of the deal, the manner in which imports are delivered (i.e. in stages or all at once) and the type of products that are to be exported.
- The amount of freedom the developing country has in controlling the account, and the mechanism for altering agreement terms should this be deemed necessary.
- Agreement on timing and mechanism for either paying into the account, or having funds released from the account and the documentation required for drawing from the account.

- Whether or not part-drawings are allowed.
- The role of the commercial bank, which may vary from simple account management to covering imbalances if the account falls into short-term deficit.
- Disposal of any residual balance.
- How and to whom interest in the account should be made payable.
- Time limit for execution of transaction.
- Laws governing the agreement and procedures for communication.
- Clauses covering arbitration, force majeure, etc.
- The provisions required by the bank in order to remove the bank's risk if one party fails to fulfil its payment obligations to the account.

In practice, escrow contracts can take considerable time to negotiate and may produce very lengthy documents as a result.

An example of the operation of an escrow account in a barter style deal is given in section 3.4.

7.6.3. Trust Account

The mechanism of the trust account is similar to that of the escrow. The principal difference is that the trust account is defined according to British law, under the Trust Act, and therefore a full agreement, as in the case of an escrow agreement, need not be drawn up for each new transaction. Any bank acting through its British subsidiary, or any country with a system based on British law, can use this technique.

According to the Trust Act:

- The trust deed cannot be cancelled without the prior approval of the beneficiary (foreign partner).
- The funds in the account are protected against arrest.
- The funds can generate interest in favour of the settlor (developing country).

The trust deed is signed with the settlor and defines:

- Receipt and payment of funds out of the trust account.
- The rate and payment of interest.
- Termination of the agreement.

From the above, the beneficiary is assured that funds are available exclusively for himself.

The escrow account, on the other hand, is not ruled by a specific law, therefore the contractual documents relating to it need to be exhaustive and include a formal pledging of the funds in favour of the beneficiary in order to protect them against arrest.

7.6.4. Evidence Account

An evidence account is a mechanism enabling each side in a countertrade transaction to record product movements and payments. The account is normally held in a Central Bank or other bank as agreed by the partners.

Evidence accounts are not clearing mechanisms where sales in both directions offset one another. Each purchase transaction has to be accompanied by payment. The function of the account is to allow central co-ordination of payments and to act as a means of monitoring the trade flows. Evidence accounts are not required to balance in the short term, although limits may be set on the level of imbalances. In the longer term, towards the end of the transaction period, there may be a requirement for the account to balance, or provision for settling imbalances in foreign exchange may be made.

The use of evidence accounts is normally agreed between parties with well established trade links and a desire to maintain or increase mutual trade in the long-term. The evidence account reduces the administrative problems, through central co-ordination, of payments to and from many importers and exporters.

7.6.5. Interbank Agreement

Within the framework of many countertrade transactions, each trading party will normally be represented by a bank. In the case of many developing countries this could be the Central Bank. The role of the banks is to co-ordinate payments against documentary evidence of actual product flows. Depending on the form of countertrade and the principal parties involved, the banks may liaise to produce an Interbank Agreement.

These agreements describe the provisions for the release of funds, the time frame for payment and identify the documents against which payment will be made. Such agreements accompany long-term trade agreements, often established at government level, such as State Trading Agreements, an example of which is given in Appendix 2.