The Legal Aspects of International Countertrade

With Reference to the Australian Legal System

by

Abdolhossein Shiravi-Khozani
LLB, LLM (Tehran)

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To my wife, Mahin, and our sons, Ali, Hadi and Sajad

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Abstract

Countertrade practices have gained increasing attention since the early 1980s because many countries have required their trading partners to undertake some countertrade commitments. Many exporting companies have lost deals due to their reluctance to respond positively to countertrade demands. One of the reasons underlying such unwillingness has been the lack of knowledge about countertrade mechanisms and their potential advantages and disadvantages. Australian exporting companies have recently started to pay more attention to countertrade as a way of doing business, particularly in Asia where demands for countertrade are growing. Increasing knowledge regarding countertrade will assist more Australian companies to become involved in countertrade practices.

The purpose of this study is, broadly speaking, to provide a basis for understanding countertrade practices. In particular, however, it aims to provide assistance to trading parties to identify the problems associated with various forms of countertrade and to give them guidance in drafting countertrade contracts in the light of Australian law. This work also aims to delineate the different forms of countertrade, investigate their legal implications and examine how countertrade is viewed in international economic forums such as the Word Trade Organisation (WTO), the International Monetary Funds (IMF) and the Organisation for Economic Co-operation and Development (OECD), as well as attempting to assess its place in international economic agreements such as the General Agreement on Tariffs and Trade (GATT). It aims to be of use to people wishing to engage in some form or other of countertrade and to assist them to avoid the legal pitfalls which can occur in cases of insufficient knowledge of the legal requirements which accompany the different forms of countertrade.

Statement

This work contains no material which has been accepted for the award of any other degree or diploma in any university or other tertiary institution and, to the best of my knowledge and belief, contains no material previously published or written by another person, except where acknowledgment has been made.

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Introduction

Barter, the exchange of goods for goods, is one of the oldest forms of trade. Over the years, it has been used to finance trade whenever currency has been scarce.[1] The 1980s and 1990s, however, have witnessed a rapid change in the use of barter and barter-like transactions in world trade. Innovative and sophisticated forms of barter-like arrangements have been developed with the label of countertrade and, as they developed in various places, were rapidly adopted around the globe. Countertrade transactions have grown from an estimated 2% of total world trade in 1977 to around 20%-40% in recent years.[2] Many countries have shown interest in these kinds of transactions. Some countries have adopted countertrade policies as a means to social and economic development, while others have mandated countertrade in response to financial needs, import-export deficits, debt crises, lack of marketing facilities, intensive international competition, growing protectionism, and increasing needs for advanced technology, know-how and foreign finance to set up expensive projects and infrastructure.

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1 Dalton, "Barter" XVI(1) *Journal of Economic Issues* 181 at 189.

2 There is no consensus about the percentage of world trade which is carried out through countertrade practices. The estimation ranges from 1% of world trade from IMF to about 40%. OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 11. It has been estimated that this proportion may reach half of the amount of international trade by the end of this century. Briggs, "Back to Barter" (March 12, 1984) *Forbes* 40 at 40.

The first reactions to this trend were negative and prejudiced. Many business people, lawyers, economists and international economic institutions looked on countertrade as a cumbersome and difficult-to-manage practice, and saw it as a return to an old-fashioned practice left behind thousands years ago as money was developed. For example, a writer criticising countertrade practices said: "Like some disease-causing microbe once thought safely eradicated by modern science, they have made a startling comeback in the past few years, and they now pose a challenge to the rules, procedures, and structures of international trade."[3]

When countertrade developed, because business people explored new mechanisms to overcome various obstacles existing in the way of international trade and payments, financial institutions and lawyers had inadequate knowledge to meet their needs in financing or planning and drafting countertrade contracts. Although these innovative mechanisms had a reciprocal nature, they did not represent any classical notion of the exchange of goods for goods. It was therefore difficult to manage their legal issues by reference to rules of classical barter. As a result of the increasing interest in countertrade, a growing number of studies have been published. Most of these have analysed countertrade from an economic point of view, examining its impact on national or international economies and their potential success in solving economic difficulties.[4]

Australia, being located in the Asian region of the world, has recently started to pay more attention to countertrade as a way of generating business or opening up markets. Many

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3 Cohen & Zysman, "Countertrade, Offsets, Barter, and Buybacks" (1986) 28(2) *California Management Rev* 41 at 41.

4 The study in countertrade is not easy for many reasons including: i) the confidentiality surrounding detailed information about countertrade and the brevity with which they are publicised; ii) the extensive diversity in their forms and content; iii) the different terminology used for similar practices; and iv) their complex and complicated nature.

Australian companies have been faced with countertrade demands in the region.[5] One commentator claims that "Australia is losing millions - potentially hundreds of millions - of dollars' worth of business because it cannot, or will not, engage in barter trade".[6] A major obstacle to more Australian companies becoming involved in countertrade is that they know little about countertrade mechanisms and they are concerned about the effectiveness and success of potential countertrade deals. Financial institutions, brokers and lawyers have been slow to respond appropriately to countertrade needs, mostly because either they are not familiar with these innovative and complex mechanisms or they believe that countertrade is a coercive practice and difficult to manage.

The purpose of this study is, broadly speaking, to provide a basis for understanding countertrade practices. In particular, it aims to provide assistance to trading parties to identify the problems associated with various forms of countertrade and to give them guidance in drafting countertrade contracts in the light of Australian law. This work also aims to delineate the different forms of countertrade, investigate their legal implications and examining how countertrade is viewed in international economic forums such as the WTO, IMF and OECD, as well as attempting to assess its place in international economic agreements such as the GATT. It aims to be of use to people wishing to engage in some form or other of countertrade and to assist them to avoid the legal pitfalls which can occur in cases of insufficient knowledge of the legal requirements which accompany different forms of countertrade.

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5 The East Asian countries, for example are very active in countertrade practices and offset programs. XV(9) *Countertrade & Offsets* (May 12, 1997) at 1-2.

6 Chong, "Beast of Barter at our Door" (March 22 1985) *Business Review Weekly* 11 at 11.

This thesis is composed of ten chapters to be read in conjunction with each other for a complete understanding of the overall countertrade picture. Chapter 1 has been designed to provide a general understanding of countertrade and its variations. Countertrade is much more than an arrangement like the direct exchange of goods for goods without money common among primitive societies.[7] It is vital to distinguish between the various kinds of very sophisticated commercial arrangements which have been developed from the very basic idea of trade involving more than the exchange of goods for money - and the like. The distinguishing elements of a variety of forms of countertrade have been explained in order to draw a line between countertrade and conventional practices. Based on an analysis of the literature, the different countertrade mechanisms are grouped into eleven types. A description of each type has been provided so that it can be distinguished from other forms. Illustrative examples from reported cases have been added to emphasise their practicability in today's international trade.

Chapter 2 reviews various motives for the use of countertrade. The chapter discusses the main reasons why a country adopts a policy to encourage or mandate countertrade or why private companies engage in these unconventional ways of trading. These objectives include export promotion, financing imports, access to technology, overcoming trade barriers, staying in a market and securing supplies of raw materials.[8]

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7 Since countertrade practices resemble barter, some thought that countertrade was a return to the past. Grabow, for example, wrote that many US businesses "mistakenly believe that the term refers only to the fairly isolated occurrence of trade without money." Grabow, "Negotiating and Drafting Contracts in International Barter and Countertrade Transactions" (1984) *9 North Carolina J International L & Commercial Regulation* 255 at 257. For another example, see the following topic of an article which implies that countertrade is a return to ancient times. Beardwood, "Back to Barter: That Cumbersome Old System is Booming While World Trade Languishes. Cause for Worry?" (Summer 1983) *ICC Business World* 6. This chapter, therefore, explains that the international community has not gone back to barter but it has developed innovative and modern mechanisms of trade in response to their needs.

8 It is, however, beyond of the purpose of this research to examine whether these motives are achievable in a particular country.

Chapter 3 explains the difficulties, limitations and risks of using countertrade practices. This chapter complements the previous chapter in the sense that the advantages of countertrade should be assessed in light of its difficulties and risks. It highlights the problems and disadvantages inherent in countertrade practices as a whole or in its individual forms. These difficulties have been classified into three main groups: those caused for countertrading parties; those caused for third parties; and those caused for a nation as a whole.[9] The chapter also explains how to avoid or ease these difficulties and risks.

The rights and obligations of countertrading parties are usually specified within written contracts. In international business, it is generally held that the parties are at liberty to regulate their relationships by agreement on detailed provisions. In countertrade arrangements, a detailed agreement is more important and necessary because of the complexity and innovation involved. On the other hand, the rights and obligations of the countertrading parties, even if detailed, must be effective within the framework of a legal system. The applicable law provides an environment determining not only the validity of the contract but also its legal consequences. Moreover, the applicable law has a gap-filling function for those issues left undecided by the parties. As a result, the first step to drafting a countertrade contract is to choose a body of law governing the contracts. This issue is discussed in detail in Chapter 4.

In many countries, including Australia, the Vienna Sales Convention as a uniform substantive law applying to sales of goods may become the applicable law of the contract by force of law. Moreover, the Convention represents a widely recognised body of law in the international context which has an impact on national laws worldwide. It is therefore

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9 The impact of countertrade on world trade is dealt with separately in Chapter 10.

important to discuss whether or not the Convention covers countertrade contracts and whether its provisions are appropriate for reciprocal deals. The application of the Convention to countertrade contracts is the focus of Chapter 5.

As an alternative to drafting a detailed contract, countertrading parties may use standard countertrade forms or refer to general conditions or standard terms. Chapter 6 explains the use of general conditions, standard forms, standard terms and guides in drafting countertrade contracts. It also analyses the benefits, drawbacks and legal implications of countertrade standardisation.

Since under a countertrade transaction two sets of obligations on two opposing sides are connected to each other, Chapter 7 discusses the best format to be chosen in drafting and linking countertrade contracts. Countertrading parties generally use a preliminary agreement, known as a protocol, as a framework for their rights and obligations. This chapter deals extensively with the legal implications of protocols to examine the conditions which may produce an enforceable agreement.

Chapters 8 and 9 have been designed to deal specifically with drafting individual countertrade forms and shaping their contents. Chapter 8 focuses on three types of countertrade: advance-purchase, counterpurchase and debt-for-equity swaps. Chapter 9 explains buy-backs and build-operate-transfer (BOT) projects by which exporting parties provide materials, equipment and technology to set up a project and agree to buy back some portion of the resultant output or to be paid by revenue generated though the operation of the project.

Chapter 10 deals with a concern about the adverse impact of countertrade proliferation on world trade, especially when countertrade is encouraged or mandated by governments.

The chapter reviews the attitudes of the WTO, IMF and OECD, as three major economic organisations, to countertrade. It also discusses whether adopting a countertrade policy violates a member's obligations imposed as a result of joining these institutions.

In conclusion, countertrade is a reality in today's international trade. While more companies are getting involved in countertrade transactions, there are no international uniform rules or any established precedents to regulate them. If a dispute arises, the issue needs to be solved through analogy with other practices. It is hoped that this research will contribute, firstly to the avoidance of difficulties and their solution if they do occur, and secondly to a systematic way of looking at the whole area from the legal point of view to assist scholars and lecturers in the field of international trade.

CHAPTER 1

Definition and Types of Countertrade

Introduction

The moneyless exchange of goods for goods is one of the oldest forms of trading in the world. Before the concept of money was developed, barter was the sole method of trading and the volume traded was quite immaterial because each side had to want the goods the other side offered. Money was developed to facilitate trade between persons with diverse needs as a way out of the inherent limitations of bartering. While money has reduced the need for bartering, it has never completely replaced it. Bartering as a supplement to money-based transactions, even if quantitatively insignificant, has found its way through to modern societies. The expansion of international trade following World War II, the emergence of many new independent countries, the involvement of governments in costly infrastructure projects, the imbalance between imports and exports, the insufficiency of available hard currency, and the need for technology have induced many countries to go back to reciprocal deals in recent decades. Innovative types of reciprocal transactions have been developed in response to these developments. While barter in its simple form is close to dying out, particularly in international trade, a number of barter-like arrangements have emerged in international trade between various countries around the world.

Because these innovative reciprocal deals resemble barter to some extent, the terms *barter* and *barter-like* have been used to describe them. The terminology used by businesses and authors has generally been imprecise and vague.[1] Various terms have been used to describe countertrade in general. *Barter*, *countertrade*, *barter-like*, *linked arrangements*, *bilateral arrangements*, *parallel trading*, *counter-deliveries*, *swap*, *compensation*, and *offsets* have all been used at times as umbrella terms to cover reciprocal deal in general.[2] Similarly, the terminology used for specific types of countertrade lacks standardisation.[3]

Barter and *countertrade* are frequently used as the generic term for innovative transactions based on reciprocity.[4] The use of the term *countertrade* has been extensive during the 1980s and 1990s and it is now a well-established term in international trade and business.[5]

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1 De Miramon, "Countertrade: A Modernised Barter System" (January 1982) 114 *OECD Observer* 12 at 12.

2 Rajski, "Some Legal Aspects of International Compensation Trade" (1986) 35 *International & Comparative L Q* 128 at 129; McVey, "Countertrade: Commercial Practices, Legal Issues and Policy Dilemmas" (1984) 16 *Law & Policy International Business* 1 at 1. At time a term, such as offset, swap, barter or compensation, has been generalised to represent all types.

3 UNCITRAL, "Current Activities of International Organisations in the Field of Barter and Barter-like Transactions: Report of the Secretary-General" (1984) 15 *UNCITRAL Yearbook* at 325.

4 In the following articles, for example, *barter* is used as a generic term covering all reciprocal deals: Assaad, "It's Time to Make Barter Legitimate" (January 1984) *Euromoney* 136; Chesser, "Barter Becomes Big Business in World Trade" (26 July 1981) *New York Times* 15 col 1; Chong, "Barter Ensures Firms Give a Razoo" (September 20, 1991) *Business Review Weekly* 35; Friedland, "Whether Trade Likes it or not, Barter is Here as Long as the Global Credit Market is Tight" (September 21, 1984) *American Banker* 41; Maidenberg, "Bartering Aids Poor Nations" (January 17, 1983) *New York Times* 1, Col 3; Marino, "Bartering With the Bolsheviks: A Guide to Countertrade With Soviet Union" (1990) 8 *Dickinson J International L* 269; Tschoegl, "Modern Barter" (October 1985) *Lloyds Bank Rev* 32; and Beardwood, "Back to Barter: That Cumbersome Old System is Booming While World Trade Languishes. Cause for Worry?" (Summer 1983) *ICC Business World* 6.

5 The Report of the Secretary-General reads: "Although there is no generally accepted definition of these terms, the Economic Commission of Europe (ECE) has used the term 'counter-trade' as the generic term covering both barter and barter-like transactions." UNCITRAL, "Current Activities of International Organisations in the Field of Barter and Barter-like Transactions: Report of the Secretary-General" (1984) 15 *UNCITRAL Yearbook* at 325.

However, the use of *countertrade* as a generic term is preferable to *barter* for the following reasons: i) Since *barter* is a term used for a particular type of countertrade, it causes ambiguity as to the exact meaning of the term if it also describes reciprocal deals in general. ii) *Barter* has primitive connotations which diminishes its role in modern international trade. iii) *Barter* is a method prevalent in both international and national business, while countertrade is generally used in the international context.[6]

1. Definition of Countertrade

Due to the lack of a standard definition, the meanings given to countertrade are various, and generally rough and imprecise. Providing a precise definition covering every form of reciprocal deal and excluding non-reciprocal ones is not easy because each particular type of countertrade has been developed in its own environment and in response to particular needs. Thus, defining countertrade to cover various reciprocal mechanisms could lack precision.[7]

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6 The use of *countertrade* as a generic term has appeared in the captions of a lot of articles and books written in this area. See the bibliography.

7 The following definitions selected from various articles show some of the diverse meanings given to countertrade:

a) In its simplest form, countertrade means bartering one product for another. In its most complex form, countertrade can be a disguised form of indirect capitalist investment in socialist countries.

Baker & Cunningham, "Countertrade and Trade Law" (1983) 5 *J Comparative Business & Capital Market L* 375 at 375.

b) Strictly, the word 'countertrade' means a trade relation to oppose or to balance the effects of a contrary trade relation.

Guyot, "Countertrade Contracts in International Business" (1986) 20 *International Lawyer* 921 at 923.

These two definitions are more related to potential functions of countertrade.

c) Countertrade, as traditionally understood, is the exchange of goods for goods - a kind of international barter.

Wulker-Mirbach, "New Trends in Countertrade" (April 1990) 163 *OECD Observer* 13 at 13. This definition excludes some forms of countertrade such as offsets, buy-backs, and build-own-transfer which have widely been used.

Countertrade may be defined broadly as a transaction under which an exporter is required to fulfil certain obligations in favour of the importing party over and above the obligations an exporter usually undertakes in cash-based agreements. For example, a foreign exporter may be required to counter-import certain products from the importing country. This obligation is extra to the normal obligations undertaken by an exporter in terms of, inter alia, conformity of the goods with contractual specifications and delivery of goods by the due date free from third party's claims. Extra obligations imposed on an exporter under a countertrade transaction could include counter-purchasing of goods or services, transferring technology and skills, sponsoring projects, conducting research, constructing plans, providing marketing facilities, finding customers for the importing country's products, investing in the importing country, or producing certain products within the importing country's territory.

2. Types of Countertrade

Countertrade can be classified from different perspectives, such as size and volume, time for implementation, potential functions, or financing requirements.[8] According to the US International Trade Commission, all countertrade arrangements can be classified into five

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d) A very broad definition of a countertrade operation is one in which a sale to a foreign country is possible only if the supplier is willing to import goods from the purchasing country equivalent in value to those exported.

De Miramon "Countertrade: An Illusory Solution" (May 1985) 134 *OECD Observer* 24 at 24. This definition only covers counterpurchase.

8 At times countertrade has been classified into the four categories of *classical barter*, *commercial compensation*, *industrial compensation*, and *offset contracts*. Hennart, "The Transaction-Cost Rationale for Countertrade" (1989) 5 *Journal of Law & Economic & Organisation* 127 at 128. Sometimes these four groups are *barter*, *clearing arrangements*, *switch trading* and *compensation arrangements*. Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 76.

basic forms: counterpurchase, compensation, barter, offsets, and switch trade.[9] An OECD report classifies countertrade into two main categories, commercial compensation (including barter transactions, counterpurchase and pre-compensation) and industrial compensation (including buy-back agreements and framework agreements).[10]

In this study, the basic types of countertrade have been classified into eleven different categories. They are *barter* (pure-barter), *counterpurchase*, *advanced purchase*, *buy-backs*, *offsets*, *clearing arrangements*, *swap transactions*, *switch arrangements*, *build-operate-transfer* (BOT), *exchange of debts*, and *mandated countertrade*. In practice, however, a countertrade transaction may have the elements of more than one single category or the parties may use the name of a specific type imprecisely for another type. Moreover, certain countertrade transactions may be so innovative that they hardly fall into one of these categories. Therefore, the purpose of this classification is to provide an understanding of the basic elements of each category, rather than to draw a rigid and exclusive distinction between them.

2.1. Barter (Pure-Barter)

As mentioned above, *barter* in this study represents a particular form of countertrade parallel to *counterpurchase, buy-back,* and *offset.*[11] Under a barter transaction, goods or services of approximately equal value are exchanged without the transference of money. For example, a US multinational corporation sold $8 million in chemicals to Zimbabwe and

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9 USITC, *Assessment of the Effects of Barter and Countertrade Transactions on US Industries* (US International Trade Commission, Washington, 1985) at 1.

10 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 30.

11 Those who use *barter* as a generic term to cover every reciprocal deal usually use *pure-barter*, *simple barter*, *straight* barter, or *classic barter* to represent this specific type of reciprocal deal.

agreed to be paid in tobacco rather than cash.[12] Barter involves a straight product-for-product transaction and occurs when each trading partner wants what the other partner has. Barter, as the oldest form of countertrade, has been used for centuries within or across national borders. Its simplicity, single contract, short-term run, relatively insignificant amount of value, and absence of currency distinguish it from other types of countertrade.

Compared to other types of countertrade, barter transactions are simple in character. Specific amounts of goods or services are exchanged directly without the involvement of financial institutions to provide credit facilities to the parties. There is no need for further implementing contracts as are needed in many types of countertrade. The rights and obligations of the parties are generally set out in one single contract. Thus, the performance of each party is strongly linked to that of the other and any failure in implementation on one side affects the other side. The parties may agree to deliver simultaneously in order to minimise the risk of non-performance in either direction.[13]

Barter is generally used for transactions to be implemented through one single shipment or over a relatively short time,[14] usually less than two years.[15] For example, under a barter deal 100,000 tonnes of New Zealand frozen lamb was exchanged for 6m barrels of Iranian crude oil worth NZ$300m (US$160m) to be implemented over a year.[16] Another distinguishing characteristic of barter is that money as a means of payment is usually absent

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12 Lohr, "Barter is His Stock in Trade" (September 25, 1988) *New York Times* at 32, col 1.

13 Brown & Franklin, *Countertrade Paying in Goods and Services* (Longman, London, 1994) at 2.

14 In rare cases, however, barter deals may be organised for a long-term run. For example, Occidental Petroleum Corporation entered into a barter agreement with Poland. According to the agreement, for 20 years the Occidental would ship one million tons of phosphate rock to the Polish partner per annum and in return receive half a million tons of Polish molten sulfur annually. Weigand, "Barters and Buy-backs: Let Western Firms Beware" (June 1980) 23 *Business Horizons* 54 at 54.

15 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 22.

16 Gray, "Price Instability Hits Expansion" (February 11, 1986) *Financial Times* at 13.

from the deal. This does not mean, however, that money never comes into barter deals at any stage. In most instances, the goods and services to be exchanged are assessed in money terms, although the prices might never be stipulated in the contract, and might not reflect the market prices. It is rare that two items are simply exchanged without previous assessment of their values in a currency as may happen in local barter. Thus, the expressed value of goods in a contract may not create a real currency flow between parties.

Moreover, unlike some other kinds of countertrade, the value of goods or services to be exchanged under barter is relatively insignificant in international trade terms. Since barter is used for a short-run or a one-time commitment, its amounts are not as great as those of a long-term buy-back or offset to be completed over a few decades. For example, Ghana and China signed a barter agreement to exchange Chinese linen, bicycles, food and cotton yarns for Ghanaian cocoa. Taking into account the market price of cocoa at the time, the barter deal was worth about $4.8m which is not a large amount in world trade.[17]

The need for a coincidence of wants, the absence of financial institutions, interdependence of obligations, and the risk of non-performance make barter transaction suitable for small quantities of goods to be exchanged during a short period of time. Since it is not a good vehicle for handling large projects and long-term transactions, barter is used infrequently in today's international trade.[18]

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17 Guyot, "Countertrade Contracts in International Business" (1986) 20 *International Lawyer* 921 at 925.

18 Verzariu, *International Countertrade* (US Department of Commerce, USA, 1992) at 2.

2.2. Counterpurchase

2.2.1. The Concept of Counterpurchase

Counterpurchase is a form of countertrade under which one party exports goods or services to another and agrees in return to counter-purchase up to an agreed amount of domestic products from the importing country.[19] Counterpurchase as the most common type of countertrade has been used frequently by many countries for decades.[20] Counterpurchase was developed after World War II as a new form of bartering so as to overcome the rigidity and difficulties inherent in pure barter. Its relatively flexible features have given firms and countries the opportunity to utilise it even in modern commerce. Under a recent counterpurchase transaction, for example, McDonnell Douglas has agreed to sell eight F-18 fighters to Thailand for a price of $578 million. In return, it has also agreed to counter-purchase Thai products worth up to 25% of the overall deal.[21]

2.2.2. Distinctive Features of Counterpurchase

Three elements distinguish a counterpurchase transaction from other forms of countertrade: two distinct but linked contracts; two separate payment mechanisms; and the commitment to counter-purchase unrelated products.

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19 Sometimes this form of countertrade is known as *parallel barter* or *indirect compensation*.

20 According to a survey of American firms carried out by the National Foreign Trade Council, 55% of all countertrade transactions were counterpurchase. Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 23.

21 "Thais Sign on the Dotted Line for F-18C/Ds" (June 5, 1996) *Flight International*; available in Lexis-Nexis, News Library.

2.2.2.1. Two Distinct Contracts

In contrast to barter, a counterpurchase transaction is composed of at least two distinct contracts. Under the first contract the exporter sells goods or services to the importing party and under the second the exporter counter-purchases domestic goods or services from the importing party. In many cases, a third contract or a protocol connects these two distinct contracts to each other. Since in these cases no provision is included in either contract linking one to the other, the two contracts seem independent from each other. Alternatively, the linkage between the two contracts may be made by including a reference in either contract or in both contracts connecting the two contracts to each other. It is to be noted that if these two contracts have not been connected to each other through either a protocol or a linking provision, the contracts are legally independent, although they have been entered into simultaneously. Thus, entering into two independent contracts, even at the same time, does not constitute a counterpurchase transaction unless they are legally connected to each other in some way.[22]

Despite the fact that the two contracts of a counterpurchase transaction are prima facie independent, the commitment to counter-purchase is usually conditional on the performance of the first export contract. The first exporter usually undertakes to counter-purchase on the expectation of its own export. If the initial export contract for one reason or another is not fulfilled, the exporter will prefer not to be obliged to cause the second contract to be performed. Thus, it is always in the interest of the exporters to ensure the second contract is linked to the first so that in a case of non-performance they can cancel the counter-

22 More discussion of this can be found in Chapter 7, pages 271-275.

purchase contract. Initial exporters, on the other hand, do not usually want an automatic termination in case of a failure in completion of the first contract; rather they seek an option to maintain the second contract if the first contract encounters performance difficulties.

2.2.2.2. Two Distinct Payments

The second distinguishing feature of a counterpurchase transaction is a distinct payment mechanism for each contract. The parties often leave the issue of linkage to a protocol to make the contracts prima facie independent of each other to gain access to services of financial institutions which are usually reluctant to support linked contracts. Each contract has its own payment arrangement in terms of currency, amounts, the method of payment and the due date. For example, under a counterpurchase arrangement between Greece and Russia, Greece agreed to purchase 30,000 barrels of oil daily during a period of time at a price of $28 per barrel from Russia. In return, Russia agreed to counter-purchase certain Greek products equivalent to the value of the first contract.[23]

It should be noted that in counterpurchase the values of the two contracts are not always the same. The second contract value may range from ten percent to one hundred percent of the first contract value. Compared to barter in which the value in each direction is approximately the same, the counter-purchased goods may cover only a percentage of the price of the exported goods under the first contract. In rare cases this percentage may reach or exceed 100% of the first export value.

23 Huh, "Countertrade: Trade Without Cash?" (December 1983) 20 *Finance & Development* 14 at 15.

2.2.2.3. Unrelated Products

Another distinguishing feature of a counterpurchase arrangement is that the products planned to be purchased under the second contract are unrelated to goods or services sold under the first contract. This characteristic differentiates counterpurchase from buy-back. For example a US company exported passenger jet aircraft to the former Yugoslavia and agreed to buy particular finished products such as canned ham and tools.[24] The products to be counter-purchased are often agreed on by choosing from a list of products attached to the transaction. At times, the list only determines those products which cannot be counter-exported. Thus, the initial exporter may select any domestic product not listed. The kinds of products available for the counter-purchase vary from country to country. They may include raw materials, semi-finished or manufactured products, machinery or agricultural goods.[25] Some importing countries with more industrial capacities, however, put great emphasis on manufactured goods as the only products available for the counter-export.

2.2.3. Other Variations of Counterpurchase

At times, a variation of counterpurchase has been used which has the elements of counterpurchase with some changes. Two variations which have been used by businesses are: i) The initial exporters agree to find a customer for the importer's domestic goods instead of undertaking a counter-purchase commitment. Under these arrangements, the exporter has to find someone to counter-purchase the agreed goods. The obligation of the

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24 McVey, "Countertrade and Barter: Alternative Trade Finance by Third World Nations" (1980) 6 *International Trade L J* 197 at 199.

25 For example, in China all goods falling into the category of the *economic and technical project* whether *productive or non-productive* are available for counter-exports. XIII (10) *Countertrade Outlook* (May 22, 1995) at 6.

exporter to find someone may not be definitive enough to lead to an enforceable obligation.[26] ii) The exporter agrees to provide facilities for the importer to enable the importer to sell its products abroad. These facilities include marketing knowledge, packaging assistance, providing marketing networks and after-sale services. To some extent, these kinds of obligation suffer from ambiguity which may lead to disputes.[27]

2.3. Advance-Purchase

2.3.1. Concept of Advance-Purchase

Under an advance-purchase transaction, an exporter purchases in advance certain products from an importing party in expectation of a future export. This practice, which has particularly been used in dealing with Latin American countries,[28] is also known by various names like *junktim*,[29] *reverse counterpurchase*,[30] *progressive* or *pro-active countertrade*,[31] *pre-compensation*,[32] and *anticipatory purchases*.[33] Since the exporter has agreed to purchase in advance to pave the way for its future export, advance-purchase is a form of countertrade under which the purchase is linked to the subsequent export. For example, under a countertrade transaction Clendon Wool, a New Zealand-based company, sold a wool scouring machine worth $1.8m to Kazakhstan and agreed to be paid in Kazakh wool.

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26 For more details see Chapter 7, pages 287ff.
27 See Chapter 7, pages 283-297.
28 Kumar, *Primary Commodities: Countertrade and Cooperation Among Developing Countries* (Ljubljana, Yugoslavia, 1984) at 48.
29 Thorpe, *Economic Motivations and the Development of Countertrade* (Working Paper No 90.07, Curtin University of Technology, WA, 1990) at 16.
30 Santamaria, "Countertrade" in Horn (ed), *The Law of International Trade Finance*, (Kluwer, Deventer, the Netherlands, 1989) at 42.
31 McVey, "Countertrade: Commercial Practices, Legal Issues and Policy Dilemmas" (1984) 16 *Law & Policy International Business* 1 at 20.
32 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 30.
33 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 20.

Not being confident about getting the wool back to New Zealand, banks refused to back the deal. The parties agreed that the wool would be shipped in advance to solve the problem of financing the export of the scouring machine.[34] In this case, similar to other advance-purchase transactions, the New Zealand company agreed to purchase in advance to be able to export its own products. As a result, the exporter needs to ensure through appropriate arrangements that advance-purchase will facilitate its future export. For example, they may agree that the price of the advance-purchase contract should be deposited in an offshore escrow account to be used to pay for later exports.

2.3.2. Why Advance-Purchase?

Generally speaking, the purpose of an advance-purchase transaction is to secure subsequent exports by way of generating hard currency, meeting a countertrade requirement or maintaining trade relations. Purchasing in advance and allocating the revenue for the subsequent exports ensures the exporter of a secured payment of its later export. While under a counterpurchase arrangement the exporter is concerned about the availability and marketability of products to be counter-purchased later, by purchasing in advance the exporter not only enjoys peace of mind as to the kind of products and their availability but also secures payment for its later export.

In cases where countertrade is requested by the importing country as a condition for exports, an exporter may want to purchase in advance because the current market situation seems more suitable to purchase at that time. In these cases the exporter should ensure that purchasing in advance provides the same export opportunity as a later counter-purchase

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34 Charles, "When Barter is the Only Way" (April 1995) 125 *Corporate Finance* 23 at 23.

does. The exporter may also want to ensure that the right to export, given as a result of purchase in advance, will be transferable to third parties who may want to export to that country.

In some cases, an exporter that has been counter-purchasing products under a countertrade transaction will want to continue its purchase after the completion of the counter-purchase commitment. The exporter may agree to continue purchasing on the condition that the revenue should be used for further exports. Suppose under a countertrade deal between a US mining company and India, the mining company agreed to supply equipment to extract coal in India. In return, it undertook to counter-purchase the coal extracted through using the equipment. Suppose further that after the completion of the countertrade contract, the mining company has an established market in East Asia and wants to maintain its market share there. The mining company may agree to continue purchasing coal under an advance-purchase scheme according to which the revenue may be allocated for further export from the mining company to India.

2.3.3. Variations of Advance-Purchase

Since the main reasons underlying advance-purchase arrangements are related to generating hard currency for later exports or penetrating a market, some specific mechanisms have been developed in this regard to facilitate such transactions. The General Foods Trading Company and the Bank of Boston have developed an *International Trading Certificate* (ITC).[35] The ITC is a document issued by an exporter which has purchased in advance some products from a country and endorsed by the relevant government agency or the

35 See Chapter 8, pages 353-357 for more details.

central bank of that country. Under the ITC, the holder has an irrevocable right to export goods to the country up to the value of the products purchased in advance. The ITC as a certificated transferable document can be traded in the world market and its holder can export products to that country.[36]

Under a second mechanism, the US Government and banks, instead of undertaking an advance purchase, have offered African governments an opportunity to export primary products and warehouse them within the US. While African exporters retain the title to the products, the US Government issues a document known as the *certificated warehouse-keeping*, as collateral security to enable the African exporters to obtain credit to purchase US products. While the African debtor does not have to sell the warehoused products immediately, when it does sell them, the proceeds must be dedicated to servicing the debt incurred through its purchase. Moreover, if the African partner is not able to pay at the due time, and the products are still unsold, the lender can force the owner to sell the commodities and will receive the proceeds. It should be noted that the African owners have no obligation to sell the products within the US. However, the burden of finding a favoured purchaser and choosing an appropriate time is upon the African owner.[37]

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36 Boliek, "International Trading Certificates" in Korth (ed), *International Countertrade* (Quorum Books, New York, 1987) at 105.

37 Kumar, *Primary Commodities: Countertrade and Cooperation Among Developing Countries* (Ljubljana, Yugoslavia, 1984) at 50.

2.4. Buy-Back

2.4.1. The Concept of Buy-Back

In some reciprocal deals, the exported and counter-exported goods are linked through the production process. In these instances, an exporter supplies equipment, materials, technology, know-how or other technical assistance to an importer to set up a productive plant and undertakes to buy back the output of the plant in return. There are different terms used in the literature for this kind of countertrade. The most prevalent ones are *buy-back* and *compensation* although the former is more frequent.[38]

Buy-back covers a wide range of arrangements in which one party provides some goods or services to an importing party to establish, develop or update an economic plant[39] and agrees to purchase back a portion of the goods or services produced in that plant. Various facilities could be supplied under a buy-back transaction, including machinery, materials, technology, software, know-how, management services and licences. The facilities provided by the exporter may lead to setting up a factory, establishing a refinery, updating an existing plant, developing and exploiting oil fields or other mines, erecting oil or gas

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38 In addition to *buy-back* and *compensation* used frequently in the literature, *industrial compensation*, *industrial cooperation* and *off-take* are also used from time to time.

39 Finland's Outokumpu, for example, offered a $640 million project to renovate Russia's Pechenga nickel smelter on the Kola peninsula on a buy-back basis to be paid off by cathode nickel and cathode copper. "Finns Use Countertrade to Finance Russian Industrial Clean Up" (December 18, 1992), *International Trade Finance*, Section: Finance/ Business; available in Lexis-Nexis, News Library.

pipelines, or even improving agricultural industries.[40] The resultant output to be bought back may be oil, gas, chemicals, copper, semi-finished products, or manufactured and finished products.

Buy-back has been initiated in centrally-planned countries in order to access Western advanced technology and sell the output to them in return.[41] These centrally-planned countries have also used buy-backs to export their expertise to other countries particularly to the developing world. In a rare example of buy-back, Romania agreed to supply mining and other necessary equipment for an iron ore mine to Australia and undertook to purchase back a portion of the ore extracted.[42] More commonly, notable cases of buy-back can be found in Eastern Europe, Russia and China in their relations with Western industrialised countries or with developing counties.[43] Buy-back arrangements have crossed the borders of centrally-planned countries to almost all countries whether as exporters or importers. After the collapse of the Soviet Union, the significance of buy-back arrangements has not diminished in these countries.[44] On the contrary, the necessity of massive inflows of foreign technology and assistance to Eastern Europe and the CIS[45] has led to an increased emphasis on buy-back transactions in these countries.[46]

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40 For example, under a buy-back arrangement between France and India, Pechiney Ugine Kuhlmann, a French company, provided an alumina refinery and aluminium smelter. Out of $2.1 billion worth of the project, France financed $1.2 billion and agreed to buy 400,000 m.t./year of alumina for an unspecified number of years. "Countertrade Arrangements Feature Barter and Buy-backs" (June 2, 1982) *Chemical Week* at 40.

41 Blum, "The East-West Business" (June 8, 1987) *Financial Times* at 16; "Growing Worries over Buy-back Deals" (June 2, 1982) *Chemical Week at 38.*

42 Hennart, "Some Empirical Dimensions of Countertrade" (1990) *J International Business Studies* 243 at 259.

43 Rubin, *The Business Manager's: Guide to Barter, Offset and Countertrade* (The Economist Intelligence Unit, London, 1986) at 15.

44 Geert Jan Leest, the senior manager with the specialised commodity finance group at MeesPierson, said: "Buy-back will be a big thing in Russia in the future". Bell, "Self Help Financing" (April 1995) 5(4) *Central European* at 65; available in Lexis-Nexis, News Library.

45 On December 12, 1991, the Commonwealth of Independent States (CIS) was founded by Russia and ten other former Soviet republics.

46 "Buy-back Boosts East-West Trade" (September 25, 1992) *International Trade Finance*, Section: Finance/Business; available in Lexis-Nexis, News Library.

A well-known example of buy-back schemes was the arrangement between the former Soviet Union and a consortium of companies from West Germany, France, Italy, and Britain. Under the agreement the consortium participated in constructing a Soviet gas pipeline from Siberia to Europe and agreed to be paid in natural gas flowing through the pipeline.[47] Another example is the case of Pandol Brothers Incorporation of California with Friendship Orchards in Fuijan, China. Under this transaction, the USA partner planned to provide saplings and equipment for growing two species of oranges. In return, the Chinese party was required to repay with its orange export earnings over the ensuing ten-year period.[48]

2.4.2. Distinctive Features of Buy-back

There are some key elements which distinguish a buy-back transaction from other forms of countertrade. Long term implementation, a relatively high volume of trade, a tight linkage between exported and counter-exported goods, and two separate contracts are the key distinctive elements of buy-back agreements.

A buy-back transaction often takes a long time to be completed because depending on the volume, the magnitude and the importance of the project, the contract may need a period of time ranging between three years and several decades to be implemented. Establishing a major project to come on stream to produce generally takes a considerable time. In addition, a period of time is also needed for implementing the buy-back commitment

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47 Forker, "Accepting Soviet Goods in Countertrade: Problems with Product Quality" (March 22, 1990) 26(2) *Journal of Purchasing and Materials Management* 13 at 13; Hewett, "The Pipeline Connection: Issues for the Alliance" (Fall 1982) *Brooking Review* 15 at 15.

48 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 24.

undertaken by the initial exporter. It is often impossible to produce in a single run or over a short time period sufficient goods to cover the whole cost of the project. Even if the plant has such a capacity, an enormous flow of finished or semi-finished products to the market generally seems undesirable for the initial exporter who wishes to sell them at a good price. Moreover, the disposal of a huge amount of goods in a market may bring about dumping allegations.[49] Thus, the time taken to construct the project plus the time required for purchasing back the output place buy-back in the category of long-term contracts. There is always a gap between the supply of facilities under the first contract and the purchase back of the output under the second contract.

Buy-back transactions are usually used to establish large and costly projects. In many instances, the initial exporter furnishes capital, equipment, materials and technology to set up a project in a foreign country. Thus, the total value of such projects is often much greater than in the case of a counterpurchase transaction and often reaches hundreds of millions of dollars, especially in infrastructure projects.[50]

The third distinguishing feature of buy-back is that the productive facilities provided by the initial exporter are linked in a productive process to the counter-exported goods. The products required to be bought back in the counter-delivery are those manufactured or extracted as a direct result of the plant establishment. A US company, for example, entered into an agreement with Romania to build a tyre factory there. In return, it agreed to purchase back a specific quantity of tyres manufactured there.[51] Another example is an agreement under which International Harvester was to supply the design and technology for

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49 Rinaldi, "Can US Anti-dumping Law be Effectively Applied to Countertrade Transactions?" (1987) 19 *Case Western Reserve J of International L* 441 at 441.

50 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, France, 1981) at 23.

51 Grabow, "Negotiating and Drafting Contracts in International Barter and Countertrade Transactions" (1984) 9 *North Carolina J International L & Commercial Regulation* 255 at 258.

a Polish tractor factory, in return for which International Harvester undertook to buy back tractor components manufactured in Poland to ship to a subassembly plant in Britain.[52] It is to be noted that if unrelated products are to be purchased back, the transaction resembles a counterpurchase contract rather than a buy-back one.

The fourth distinctive characteristic of buy-back is that buy-back does not usually involve the exchange of plant and equipment for the resultant output as is the case in pure barter. Instead, buy-back stipulates two parallel money transactions.[53] Under the first contract the machinery or materials are paid for by the buy-back purchaser from its own pocket or from money borrowed. Under the second contract, the price of the output is to be paid by the buy-back seller directly to the lender or to the buy-back purchaser. There is often no cross-reference term connecting the first contract to the second. Nevertheless, the second contract, indicating the obligation of the initial exporter to purchase back the output, may include a term linking the second contract to the first. In many instances, however, these two contracts are drafted entirely separately from each other and a third connecting contract, known as the protocol, regulates the reciprocal relationship of the parties. It should also be noted that the prices in these two contracts are not always the same. The amount of goods required to be purchased back ranges from ten percent to one hundred percent of the price of the first contract. At times, the total value of buy-back goods exceeds the price of the first contract, especially in mining development projects.

In brief, buy-back is one of the most recent forms of countertrade and is a transaction wherein an exporter, usually from an industrialised country, agrees to supply manufacturing

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52 "Barter and Countertrade: a New Upsurge" (October 1978) *The Morgan Guaranty Survey* 12 at 12.
53 McVey, "Countertrade and Barter: Alternative Trade Finance by Third World Nations" (1980) 6 *International Trade L J* 197 at 202.

equipment to another country and in a separate, but likely linked contract, undertakes to purchase a specific quantity of the resultant output from the facilities provided.

2.5. Offsets

2.5.1. Introduction and Definition

Offsets refer to those transactions by which a government purchases highly sophisticated projects or items from an industrialised party on the condition that the exporter undertakes to cooperate with domestic industry to produce certain components of the project within the importing country, to involve participation of local contractors in the project, to employ and train the local staff, to transfer technology and skills, or to render assistance to the importing country in regard to related or unrelated economic activities. The exporter's undertaking may range from ten percent to one hundred percent of its export. For example, Daewoo Heavy Industries (DHI) signed a railway sale with Taiwan worth NT$7.3b on an offset basis under which DHI undertook to purchase NT$1.08 worth of rail car parts manufactured in Taiwan. The parts to be purchased by DHI include seats, electrical fans, and glass which constitutes 15% of the original export.[54]

Countertrade in the form of offsets came into existence after World War II in a different environment compared to other types of countertrade. Offset programs emerged between industrialised countries for sophisticated military projects and industrial cooperation, particularly in defence-related and aerospace industries.[55] The involvement of developed

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54 XIII(17) *Countertrade Outlook*, (September 11, 1995) at 9.

55 Eighty percent of US countertrade obligations during 1980-84 were related to military offsets required by Western European countries. Park, "Policy Response to Countertrade and the US Trade Deficit: an Appraisal" (April, 1990) 25(2) *Business Economics* 38 at 44.

countries in offsets has not come about as a result of difficulties in obtaining finance or a lack of hard currency. Rather they view offsets as a means for the transfer of advanced technology, the participation of domestic contractors or producers in the projects, and export development.[56]

Two key developments have occurred with respect to offset programs since the early 1970s. First, the industrialised countries have started to employ offsets in civil projects as a vehicle for creating new employment opportunities, establishing long-term industrial cooperation, gaining access to technology and skills, and involving local enterprises in large projects of national significance. Second, the developing countries have realised the benefits of offset programs in both military and civil sectors. As a result, offsets are no longer characterised as a form of countertrade between Western industrialised countries for purely military purposes.

Offset programs, however, could be characterised as a form of countertrade which involve costly and large government purchases projects. The expenditure of a government on goods and services constitutes a significant part of the country's trade activities. A government has to spend on military-related equipment, infrastructure projects and on goods and services required for the functioning of governmental offices and departments. Governments are keen to use their unique economic strength to achieve certain social objectives by means of offsets programs. For these reasons, offset programs have become

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56 A report reviewing offset programs in Australia remarked that:

> Australia's Offsets program is quite different from the mainstream of world countertrade, and should be recognised as being different. Australia has no particular balance of payments problems, pays cash for its Government purchases overseas, and is not seeking to force any particular Australian products on to world markets by these means. The main motives for Australia's Offsets program are to open new markets, to obtain technology and skills and enhance its defence capability.

Report of the Committee of Review on Offsets (Australian Government Publishing Service, Canberra, 1985) at 96.

an increasingly common element of government purchases, particularly in the international arms trade.[57] Most OECD countries use offsets within themselves or with other countries for military or civil purposes.[58] Greece, Spain, the Netherlands, Belgium, Canada, Israel, New Zealand, and Australia are among OECD countries which actively pursue offsets. Inside and outside the OECD, there are many countries which require offsets for government procurement by means of legislation or national policy like Australia,[59] New Zealand, South Africa,[60] Netherlands,[61] the Philippines,[62] and South-East Asian countries,[63] and the Persian Gulf countries of Saudi Arabia, Kuwait and the United Arab Emirates.[64]

2.5.2. Types of Offsets

In terms of the kind of obligation undertaken by the exporter, offset transactions are classified into two categories: direct and indirect offset programs.

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57 The reasons underlying the extensive use of offsets in military-related projects include: i) the military world market is increasingly occupying an important part of international trade; ii) military equipment is relatively expensive and its industry needs advanced technology and huge investments; iii) transferring military equipment requires great political consideration; and iv) competition in the military market is very keen. Today offset programs have been extended to sophisticated projects in the civil sector like nuclear technology and equipment, passenger plane communication systems, bio-technology, medical products and infrastructure projects.

58 "Offsets in Defense Trade" (1996) 117(9) *Business America* 155 at 161-162.

59 See generally *Report of the Committee of Review on Offsets* (Australian Government Publishing Service, Canberra, 1985).

60 For example, South Africa has recently set a 50% offsets requirement for all long-term government purchases. XV(3) *Countertrade & Offsets*, (February 10, 1997) at 1.

61 The Netherlands imposes a 100% offsets requirement on all government purchases worth more than Dfl 5m. XIV(21) *Countertrade & Offsets*, (November 11, 1996) at 1.

62 Section 10(B) of the Modernisation Act of the Philippines reads:

> The Secretary of National Defense shall, as far as feasible, incorporate in each contract/agreement special foreign exchange reduction schemes such as countertrade, in-country manufacture, co-production, or other innovative arrangements or combinations thereof.

XV(4) *Countertrade & Offset* (February 24, 1997) at 1.

63 For offset programs in South-East Asia see Shanson, "Building on Offsets" (December 15, 1990) 14(24) *Jane's Defence Weekly* 1248.

64 Cave, "Offset Programmes in the Gulf" (April 1995) *International Financial L Rev* 45 at 45.

2.5.2.1. Direct Offsets

Whenever the exporter's undertaking is something related to the item or project exported, a case of direct offset occurs. For example, if the exporter undertakes to co-produce some components of the project within the territory of the importing country, the transaction will be a direct offset program. Based on the obligation undertaken by the first exporter, direct offsets could be classified into three types.

Under the first type of direct offsets the exporter supplies goods or services of high value and agrees to purchase certain component parts from the importing country to incorporate them in the project. The exporter may be required to enter into a sub-contract with the local producers for manufacturing those parts. For example, under a direct offset arrangement between Tunisia and a consortium of automobile manufacturers, Peugeot and Volkswagen undertook to purchase local electronic and mechanical components to be incorporated into the cars produced in the agreed project in Tunisia.[65]

Under the second form of direct offset arrangement, the exporter is required to co-produce some component parts within the purchasing territories and use them in the project exported. The coproduction requirement allows the importing country to gain access to the sophisticated knowledge, skills and technical information needed to manufacture such component parts. It also creates new employment opportunities in the importing country.

In the third form of direct offsets the exporter is required to invest in the purchasing country in relation to the production of the goods sold under the first contract or to form a joint venture within the importing country to produce those products by utilising the capital and

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65 Wulker-Mirbach, "New Trends in Countertrade" (April-May 1990) 163 *OECD Observer* 13 at 14.

technology of the exporting country. In some instances the exporter may be required to transfer the technology of such goods or even to grant production licences to the importing country. The exporter may also be required to market the remaining output of the project.

2.5.2.2. Indirect Offsets

There are various transactions which can be classified under indirect offset arrangements. All of them share the aspect that the exporting partner undertakes to provide the purchasing country with some assistance which is unrelated to the goods or services exported. The assistance provided by the exporter includes:

i) Investment: in some instances, the purchasing country agrees to buy something provided that the exporter invests a specific portion of the contractual price in the importing country. For example, the US Boeing Company entered into a contract to sell AWACS (Airborne Warning And Control Systems) to Saudi Arabia with an offset requirement of investing 35% of the contract value in high-technology projects inside Saudi Arabia.[66] The investment aimed at promoting industrialisation in areas not related to the first export.

ii) Marketing assistance: the exporting party may be required to grant some assistance to the purchasing country to enable it to access world or regional markets. The marketing services include finding consumers for finished, semi-finished or raw goods, furnishing advanced knowledge of marketing, setting up a joint venture to carry on market activities, and providing marketing networks and after-sale services.

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66 Montague, "An Introduction to Countertrade" (1989) 17 *International Business Lawyer* 360 at 365.

iii) Other benefits: in addition to investment and marketing support, there are many offset transactions requiring the initial exporter to counterpurchase unrelated goods from the importing country, to transfer technology or to grant licensed production of unrelated products to the purchasing country. Under an offset transaction, the Japanese company Fujitsu was required by Australia to financially support a research program in Australia for three years.[67]

While direct offsets are similar to buy-backs in terms of legal technicality and long-term status, indirect offsets resemble counterpurchase. The peculiarity of *offsets* lies in their close connection with government procurement, particularly in military-related projects, and civil plans of national importance. Otherwise, offset programs can be classified as either buy-back or counterpurchase.

2.6. Clearing Arrangements

2.6.1. Introduction

In a multilateral trade system traders export their products freely to various countries against convertible currencies. Some countries, however, do not have enough hard currency to pay for their purchases, nor is their currency convertible in the world market. As a way out of the problem, a bilateral trade and payment arrangement may be set up by two countries to facilitate trade between themselves and solve the problem of payment. Although recent years have witnessed a decline in the use of clearing arrangements,[68] a

67 Thorpe, *Economic Motivations and the Development of Countertrade* (Working Paper No 90.07, Curtin University of Technology, WA, 1990) at 10.

68 IMF, *Annual Report on Exchange Arrangement and Exchange Restrictions* (IMF, Washington, 1983) at 44.

number of countries with hard currency shortages and exchange restriction policies continue using or maintaining bilateral payment arrangements. Thus, the use of clearing arrangements is closely connected with hard currency shortages, import restrictions, inconvertibility of currency and multiple exchange rate practices. Clearing arrangements are generally a government-to-government agreement which is signed by the involved central banks. However, the arrangement may be set up by a government on one side and a foreign private company or a group of companies on the other side.[69] When a party to the arrangement is a private company, the transaction is also known as *evidence account*.[70]

2.6.2. Definition and Illustration

Clearing arrangements are bilateral trade and payment agreements, generally between two governments, to exchange a specific amount of products over a stated period of time without transferring money. As a result, each country opens in its Central Bank a clearing account in the other's name, extending an agreed credit to be paid to those traders exporting goods or services to the other country. Exports to either country will be paid within the limit of the credit by their own Central Bank and accordingly the respective account will be debited. The two Central Banks settle the accounts imbalances when the stated time is elapsed. While the credit is generally designated in one of the convertible currencies, the money given to the exporters is usually in the local currency. An exchange

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69 For example a consortium of four Malaysian banks and Iran set up a clearing arrangement. "IDB Sets up Countertrade Fund" (April 20, 1989) *International Trade Finance*, Section: Finance/Business; available in Lexis-Nexis, News Library.

70 Welt, "Unconventional Forms Of Financing: Buy-Back/ Compensation/ Barter" (1990) 22 *New York Uni International Law & Politics* 461 at 463; Thorpe, *Economic Motivations and the Development of Countertrade* (Working Paper No 90.07, Curtin University of Technology, WA, 1990) at 14.

rate, therefore, needs to be fixed for exchanging the local currencies to the hard currency designated for the clearing accounts.

For example, in 1964 the former Soviet Union and Iran entered into a clearing arrangement under which their respective Central Banks were required to open a clearing account in the name of the other country in US dollars, granting each other a credit of $2m. The Iranian exporters to the Soviet were to be paid by $2m credit given by Iran's Central Bank. The Soviet exporters to Iran were to be paid by $2m credit given by the Soviet's Central Bank.[71] This agreement provided an opportunity for the traders of either country to export around $2m to other country without actual transfer of money from one country to the other.

The following hypothetical example would further illustrate the mechanism of a clearing arrangement. Suppose India and Hungary, having financial difficulties, sign a clearing arrangement to exchange annually about one million US dollars worth of products over a period of five years. India opens an account in its Central Bank in the name of Hungary, providing $1m credit to Indian traders which export goods to Hungary. Hungary also opens an account in its Central Bank in the name of India, providing similar credit to Hungarian exporters to India. Since each Central Bank pays the exporters of its own country in local currency, the parties need to agree how many units of each country's currency equal one American dollar. Suppose further that they fix every twenty units of Hungarian currency and every thirty Rupees as equal to one US dollar. Accordingly, Indian traders which export goods to Hungary will be paid up to 30m Indian Rupees and Hungarian traders will be paid up to 20m Hungarian Forints. In making any payment, either party debits the other party's account held in its Central Bank in US dollars.

71 For an English translation of the agreement see 4 *International Legal Materials* (1965) at 152-156.

2.6.3. Contents of Clearing Arrangements

In a clearing arrangement the following issues may be agreed on: i) the amount and the type of goods or services to be exchanged under the arrangement; ii) the hard currency designated for the account; iii) a rate for the exchange of local currencies to the designated currency; iv) the total time period of the arrangement; v) the maximum imbalances which may occur at any point over the life of the arrangement; and vi) establishing a method for settling the imbalances which occur between the two accounts.

By the end of the agreed period of time (the end of each year or the end of the arrangement length) the potential imbalance between the two accounts would be managed by using one of the following four methods. First, the parties may agree to carry the imbalance over to the new year. Second, the imbalance may be compensated by cash payment by the indebted party. Third, the creditor may have to buy products from the other country equivalent to the trade imbalance. Finally, the agreement may permit the creditor to transfer the unused credit to a third party which wants to purchase products from the indebted party through a *switch agreement*.[72] Under the switch arrangement, the unused credit is transferred against cash to a switch trader to be used for purchasing certain products from the country having a surplus in its clearing account.

It should be noted that in many instances contracting parties agree on a maximum amount of imbalance (swing) which may arise at any moment over the life of the arrangement. The

72 For example in a clearing arrangement between Brazil and East Germany a trading imbalance arose since Brazil had bought 30 percent more machinery than Germany had bought coffee. East Germany, however, did not want to buy coffee any longer. A trading house in London found a buyer for the coffee which the East German partner had undertaken to accept. Weigand, "Apricots for Ammonia: Barter, Clearing, Switching, and Compensation in International Business" (Fall 1979) XXII(1) *California Management Rev* 33 at 36.

swing is usually set at a percentage, such as 30%, of the total value of trade to be made within a period of time.[73] When the amount of the trade imbalance reaches the given maximum, further trade may be suspended unless the imbalance is settled by the parties. Trade may be resumed only when the party which has purchased less uses its credit to purchase more. If the party purchasing less no longer has any interest in purchasing more goods, the arrangement may stipulate a mechanism for switching the rights to the trade imbalance to a third party against hard currency at a discount.

2.7. Switch Arrangements

The trading parties supposedly have a coincidence of wants when they enter into a countertrade transaction; one party needs what the other supplies and offers what the other needs. In practice, however, a party who undertakes to purchase certain products under a countertrade agreement may not need the products supplied by the other party. For example, in a number of clearing arrangements one of the contracting parties purchases more than it sells. By the end of the arrangement, an imbalance may have arisen between two accounts while the party having purchased less is no longer interested in purchasing the products supplied. The imbalance during the life of the arrangement may lead to the suspension of the contract if the imbalance goes beyond the maximum trade imbalance (swing) specified in the arrangement. To settle the accounts or to resume trade, the party purchasing less may transfer the unused credit to a third person through a switch arrangement.[74]

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73 Elderkin & Norquist, *Creative Countertrade: A Guide to Doing Business Worldwide* (Ballinger Publishing Company, Cambridge, 1987) at 10.

74 In a clearing arrangement unused credits may be sold through the facilities of trading houses to a third person. For example, Greece sold one million dollars of Romanian credits for 700,000

A switch arrangement is an assignment agreement by which one party, instead of accomplishing its counter-purchase obligation by itself, assigns the given obligation to a third party.[75] The third party can be a trading house or a switch trader having experience in handling countertrade goods[76], or an end-user company. In cases where the third party fulfils the obligation as an agent for the obliged party, the agreement does not generally need the obligee's consent and it is not a switch arrangement. Switching the counter-purchase obligation to a third party generally needs the obligator's consent.[77] This consent may be provided in the agreement authorising a party to switch the obligation to a third party or it may be obtained later through negotiation with the obligator. Although in the literature *switch* has been classified as a form of countertrade parallel to other types of countertrade,[78] it seems that switch arrangements might not be a type of countertrade like counterpurchase, offsets or buy-back because switch arrangements are dependent on a main countertrade agreement and are not perceived as an independent form of countertrade. A switch arrangement is rather a mechanism to deal with the countertrade obligation which is totally or partially unfulfilled. If the third party participates in the main countertrade negotiation as a party, a trilateral countertrade transaction may be entered into which is not a switch transaction. Under a trilateral arrangement, the exporter exports goods to a

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dollars of hard currency. Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 77.

75 Sometimes both *switch* and *swap* arrangements are named *cross-cutting countertrade arrangements*. Welt, "Unconventional Forms of Financing: Buy-Back/ Compensation/ Barter" (1990) 22 *New York Uni International Law & Politics* 461 at 464.

76 Westfall, "Switch Traders" in Korth (ed), *International Countertrade* (Quorum Books, New York, 1987) at 121.

77 For more details see Chapter 8, pages 328-331.

78 Montague, "An Introduction to Countertrade" (1989) 17 *International Business Lawyer* 360 at 362; McVey, "Countertrade and Barter: Alternative Trade Finance by Third World Nations" (1980) 6 *International Trade L J* 197 at 203; Thorpe, *Economic Motivations and the Development of Countertrade* (Working Paper No 90.07, Curtin University of Technology, WA, 1990) at 17; Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 10; and Welt, "Countertrade Gains Popularity as International Trade Tool" (July 14, 1980) *Business America* 12 at 15.

country while the third party undertakes to counter-purchase products from the importing country. The third party may pay the price of counter-purchased goods to the seller or to the initial exporter in accordance with the agreement.[79]

In some instances, the purpose of a switch arrangement is for a party to overcome trade obstacles in its way to gaining access to a market. Suppose China has imposed certain restrictions on imports or on making payment in hard currency and an Australian company wants to have access to the Chinese market. Suppose further that China has had a clearing arrangement with India under which up to $100m worth of products have been to be exchanged in each direction over a year. After one year, although India has purchased $100m worth of Chinese goods, China has purchased only $60m. As a result, $40m unused credit is available for China to buy Indian products. Under a switch arrangement between the Australian company, India and China, China may use the remaining credit to buy Australian products. In return, the Australian company may be paid by Indian products or by hard currency at a discount. By using this method, all parties are satisfied, China purchases Australian products rather than Indian products, the Australian company exports to China, and India either exports its products to Australia or pays less hard currency than the credit recorded under the clearing arrangement.

2.8. Swap Transactions

Under a swap transaction, similar products from different locations are exchanged in order to reduce transportation costs or to overcome transportation barriers.[80] Suppose Indonesia,

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79 Under a trilateral arrangement between Tajikistan, Turkmenistan and Iran, Tajikistan would purchase Turkmen gas and pay Iran in cotton. Turkmenistan would be paid by Iranian goods for the gas exported to Tajikistan. XIII(23) *Countertrade Outlook* (December 11, 1995) at 8.

which has to deliver oil to its trading partner in Germany, discovers through relevant market sources that England has to deliver similar oil to New Zealand. To reduce the transport costs, these parties may enter into a swap arrangement under which the Indonesian oil is shipped to New Zealand and in return English oil is shipped to Germany. The exchange of Indonesian oil for English oil can help the parties to reduce the costs of shipping.[81]

Sometimes swap is used to overcome the transportation barriers being in the way of export. For example Kazakhstan has a difficulty in exporting its oil to the world market because its export through the Russian pipeline system has been capped at only 60,000 barrels per day. To overcome the problem, Iran and Kazakhstan have entered into a swap transaction under which around 40,000 barrels of crude oil per day are to be shipped to Iran's Tehran and Tabriz refineries in exchange for a similar quantity of Iranian Light crude to be provided in the Persian Gulf for export to Kazakhstan's trading partners.[82] By means of swap, the first delivery of Kazakh oil to the world market was made in January 1997.[83]

This technique is suitable for those products which have internationally recognised standardisation regardless of their sources, such as oil, chemicals and other raw materials. Although this method is generally used in the oil trade, other materials may also be exchanged through swap. For example, a South Korean steel firm purchased a certain amount of ore from a US company, meanwhile an Australian company sold the same type of ore to a Mexican company. These four parties came into a swap arrangement whereby the

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80 This kind of countertrade, along with *switch* is known as *cross-cutting countertrade*. Welt, "Unconventional Forms of Financing: Buy-Back/ Compensation/ Barter" (1990) 22 *New York Uni International Law & Politics* 461 at 464. At times, *swap* has been used in place of *pure-barter* or *countertrade*. Bardacke & Gray, "World Trade: Thais in Swap Deal for Fighter Aircraft" (May 31, 1996) *Financial Times* at 6.

81 Harben, "Countertrade - Impact on Trade and Shipping" (March 1986) 6(3) *International Bulk Journal* 83 at 83.

82 *ETTELA'AT International* [An International Persian Daily Newspaper] (August 12, 1996) at 10.

83 XV(4) *Countertrade & Offsets* (February 24, 1997) at 6.

Australian ore would be shipped to South Korea and in return, the US company would undertake to ship ore to Mexico.[84]

Since swap can help the parties to reduce the transportation costs, it may also be used within the borders of a country. For example, Ampol, which operated a petrol refinery at Lytton in Queensland, had no refinery in New South Wales and needed to ship the petrol to NSW. Similarly, Caltex, which had a refinery at Kurnell in New South Wales, needed to ship petrol to Queensland. To reduce the cost of shipping, they entered into a swap agreement for the exchange of the petroleum products of their respective refineries. By means of this swap agreement, each party could obtain from the other petroleum products in the State in which it had no refinery but wished to market the products.[85]

2.9. Build-Operate-Transfer (BOT)

2.9.1. Introduction

Investment in infrastructure projects is essential for the development and economic growth of a country. The necessity of investment in infrastructure is being widely recognised by governments all around the world and implementing such massive infrastructure projects is generally sponsored and accomplished by governments. Because financing and managing these demanding and costly projects has not always been an easy task, a number of governments are not able or are reluctant to finance these expensive projects. As the need for greater infrastructure projects puts governments under pressure, the necessity of

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84 McVey, "Countertrade and Barter: Alternative Trade Finance by Third World Nations" (1980) 6 *International Trade L J* 197 at 203.

85 *Ampol v Caltex* (1986) 63 ALR 540 at 541.

dependence on the private sector seems inevitable. The private sector not only provides the finance necessary for the projects but also tends to manage the facilities more efficiently. As a result, governments wish to shift the responsibility of financing and operating such infrastructure projects to the private sector within their own borders or abroad. They need sophisticated technology, hard and soft currency and an effective management to construct such projects.

2.9.2. Definition and the Use of BOT

One of the most recent developments in the direction of privatisation is to shift the responsibility of financing, building and operating an infrastructure project to the private sector through B*uild-Operate-Transfer* (BOT)[86] schemes. Under a typical BOT scheme, a government grants a concession to a consortium to finance, build, manage and operate an infrastructure project during a period of time, which may vary from 15 months to several decades. The consortium collects revenues through running the project so as to repay the costs of the project and to make a profit. The project is transferred to the host government at no charge at the end of the concession period. Suppose for example, the Philippine Government plans to set up a power station of 1,290 MW, estimated to cost about $1.3 million. Suppose further that the Philippines is reluctant to use a direct loan or such a loan is not available. The BOT scheme is an option for the Philippine Government to finance the project. A consortium of Pakistani companies offers a BOT scheme to construct the project. The consortium undertakes to build the power station and in return takes its

86 It is also known as Build-Own-Operate-Transfer (BOOT). Merna, Payne & Smith, "Benefits of a Structured Concession Agreement for Build-Own-Operate-Transfer (BOOT) Projects" (1993) *International Construction L Rev* 32 at 32; Gilchrist, "Challenging Times for BOOT Projects" (January 29, 1993) *Business Review Weekly* 64. At times it is known as *concession-financing*. Sington, "Limited-Recourse Shifts the Risk" (April 1989) *Euromoney* 83 at 83.

operation for seventeen years to pay off the original debt, interest and other expenses. The consortium undertakes to transfer the power plant to the Philippine government at the end of this period.[87]

BOT has attracted the attention of not only national private investors but also foreign companies. Since the mid-1980s, BOT schemes have been recognised by many developing countries especially in Asia as an alternative way of financing major projects.[88] According to the World Bank and the US Agency for International Development, some Asian countries have recently started using BOT projects while others are considering them.[89] Indonesia,[90] Malaysia,[91] the Philippines,[92] Vietnam,[93] China,[94] Hong Kong[95] Turkey,[96] Pakistan,[97] Egypt,[98] and Oman[99] are among the countries moving the implementation and responsibility of financing, constructing and operating of certain infrastructure projects to

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87 This example is from an account of a real case of the BOT practice in the Philippines. Tiglao, "Powerful Solutions; Philippine Project Shows Benefits of Build-Operate-Transfer Schemes" (July 9, 1992) *Far Eastern Economic Rev* 56 at 57.

88 Many Asian countries suffer from insufficiency in their economic infrastructure. In these countries, roads, railways, ports, aviation, communications, the water system etc fail to keep up with demand from their increasing population and development needs. They have expressed a keen interest in developing additional generating capacity since they have realised the long-term benefits of investing in infrastructure projects. For many of them, privatisation through BOT is a major option in achieving these ends.

89 Tiglao, "Powerful Solutions; Philippine Project Shows Benefits of Build-Operate-Transfer Schemes" (July 9, 1992) *Far Eastern Economic Review* 56 at 56.

90 Connors, "Infrastructure in Indonesia" (November 2, 1994) *Australian Business Asia* 7.

91 Sington, "Limited-Recourse Shifts the Risk" (April 1989) *Euromoney* 83.

92 Tiglao, "Powerful Solutions; Philippine Project Shows Benefits of Build-Operate-Transfer Schemes" (July 9, 1992) *Far Eastern Economic Rev* 56.

93 Stein, "Construction Financing and BOT Projects (April, 1995) *International Business Lawyer* 173 at 174.

94 Bateson, "New China BOT Regulations" (1997) *The International Construction L Rev* 134.

95 Bateson, "Infrastructure Development in Hong Kong Through BOT" (1997) *The International Construction L Rev* 136.

96 Tiong, "BOT Projects: Risks and Securities" (1990) 8 *Construction Management and Economics* 315 at 315.

97 Stein, "Build-Operate-Transfer (BOT) - a Re-Evaluation" (1994) *The International Construction L Rev* 101 at 110.

98 Sarie-Eldin, "Build, Operate and Transfer (BOT) Projects and the Settlement of Their Disputes" (1997) *The International Construction L Rev* 124

99 Amison, "BOTs Will Power Middle East Project Growth" (February 1997) *International Financial L Rev* 15 at 16.

the private sector by way of BOT.[100] The significance of BOT in infrastructure development and privatisation has widely been realised at both national and international levels.[101]

BOT schemes are generally used for massive infrastructure projects such as highways, rail-based projects, road-building, port infrastructure, power stations, gas and oil pipelines, oil industry and telecommunications. These projects belong to the public sector and are traditionally sponsored by governments. The use of BOT for smaller projects such as hotels, medical facilities and water treatment programs is growing as BOT is widely recognised by the international community.[102]

2.9.3. BOT and Countertrade

BOT has been categorised as a form of countertrade by some writers.[103] The reason underlying such categorisation is that BOT is based on a reciprocal business mechanism. In

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100 It was said that the BOT concept was initiated for the first time in 1984 by the Turkish Prime Minister Turgut Ozal. Tiong, "BOT Projects: Risks and Securities" (1990) 8 *Construction Management and Economics* 315 at 315. However, some projects can be found before that time for which it can be argued that while the term BOT probably has not been used, they have nevertheless been achieved in this way. For example in the 1970s the six-billion pound project of the Channel Tunnel was financed using a BOT-type mechanism. Barrett, " Project Finance Develops, New Risks" (October 1986) *Euromoney* 73 at 73. It should be noted, however, that its popularity in international business, particularly for the developing world, has come into view only in recent years. BOT has not been a well-known term in law and business up till now and is still a new notion for many people in these fields.

101 In Australia BOT schemes have received the attention of the State and Federal Governments as a way to shift from government ownership and operation of the public services to the private sector. BOT is now proposed for building power stations, water treatment plants, tollways, sewage plants and railway lines. Arbouw, "Public Benefit Private Gain" (November 1992) *Australian Business Monthly* at 88. Some public projects have already been built through BOT schemes and some more are on the way. For example the NSW Government entered into an agreement with a consortium of national and international private companies to build four water treatment plants. Gilchrist, "Challenging Times for BOOT Projects" (January 29, 1993) *Business Review Weekly* 61at 66.

102 UNCITRAL, "Build-Operate-Transfer Projects: Note by the Secretariat" (1995) 26 *UNCITRAL Yearbook* at 211.

103 Montague, "An Introduction to Countertrade" (1989) 17 *International Business Lawyer* 360 at 360; Brown & Franklin *Countertrade: Paying in Goods and Services* (Longman, London, 1994) at 25.

BOT, it is the responsibility of the consortium to finance and build the project while the host government pays nothing for it. Instead, the host government authorises the consortium to use (or in some instances to own) the project for a specific period of time to compensate the costs incurred. The consortium provides capital, technology, machinery and other necessary materials to construct the project and in return it takes possession of the given project for a limited period of time. As a result, the price of the BOT project is not paid in cash but rather by granting a concession to operate it over a period of time.

There is a similarity between BOT schemes and buy-back arrangements to the extent that under both schemes a project needs to be constructed by a party.[104] When the consortium is required to sell the resultant products or services of the project abroad, BOT schemes resemble buy-back arrangements in many technical aspects. Nevertheless, there are two factors distinguishing BOT from buy-back. First, in buy-back the project is to be financed by the buy-back purchaser either by its own money or by the loan received, while in BOT the responsibility of financing the project is upon the consortium. Second, in BOT the consortium is to operate the project during a period of time to reimburse the costs of the project through proceeds generated by the exploitation of the project. In a typical buy-back arrangement, however, the project is generally handed over to the buy-back purchaser when the construction is completed. The responsibility of the buy-back seller after the construction is to buy back a portion of the output against cash.

BOT should not be categorised as a long-term loan received by the government. In loan agreements, the lender usually has no obligation to build, design, or operate the project as is required in BOT. While in long-term loans the debtor has to pay the principal plus the

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104 At times BOT has been categorised as a variant of buy-back. See Brown & Franklin, *Countertrade Paying in Goods and Services* (Longman, London, 1994) at 25.

interest, in BOT the host government has no obligation to pay the price or to guarantee the revenue. The proceeds of the project may not reach the original expenses or may exceed them up to several times more than the original outlay. Thus, the responsibility for profitability of the project to generate sufficient revenues to cover the costs is upon the consortium. In short, despite the fact that BOT contains some elements of a long-term loan and direct investment, it is a distinct way of privatising and financing projects which can be categorised as a form of countertrade.

2.10. Exchange of Debts

The 1980s witnessed a debt crisis for many developing countries facing a problem in meeting their debt service payments.[105] The international debt crisis started in August 1982 when Mexico announced that it might not have the money to continue paying off its external debts.[106] The debt crisis has led to the design and implementation of innovative methods through a joint attempt of creditors and debtors. In addition to normal measures in dealing with debt problems, such as rescheduling or refinancing the old debt, *debt exchange*, *debt buy-backs*, *debt-for-equity* and *debt-for-export swaps* have been developed in response to the 1980s debt crisis.

Under a debt-exchange scheme, the creditor and the debtor enter into an arrangement to exchange the old debt for a new one. The new debt may differ from the old one in terms of the amount of capital, interest rates, and the conditions of repayment.[107] The creditor bank

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105 Argentina, Brazil, Colombia, Ecuador, Morocco, Peru, Uruguay, Bolivia, Chile, Cote d'Ivoire, Mexico, Nigeria, the Philippines and Venezuela are among the heavily indebted countries.

106 Reiter, "The Feasibility of Debt-Equity Swaps in Russia" (1994) 15 *Michigan J International L* 909 at 911.

107 Asiedu-Akrofi, "A Comparative Analysis of Debt Equity Swap Programs in Five Major Debtor Countries" (1989) 12 *Hastings International & Comparative L Rev* 537 at 537.

may agree to exchange its debt for a low interest loan guaranteed by the respective government. In a debt-buy-back arrangement, the indebted country purchases its external debt at a discount. This method creates an immediate cash flow for the creditor and a relief for the debtor. Chile and Bolivia have had experience in dealing with their debt in this way.[108]

Debt-for-equity swap programs, as an alternative for reducing the burden of heavy loans, involve a more complicated process. Under this program a company which wants to invest in the debtor country purchases the debt of the country from the commercial bank at a discount. The loan purchased by the investor will be exchanged for local currency at the debtor's Central Bank at a negotiated rate. The investor will use these local currencies to invest in the debtor country.[109] This scheme benefits all three parties: the initial creditor benefits from immediate access to its hard currency; the investor has access to local currency more cheaply; and the debtor country promotes increased domestic investment and enhances foreign exchange savings.

It should be noted that this practice, used in international business since 1982, has become increasingly important and widespread over the last decade.[110] Countries which have established debt-equity swap programs include Argentina, Bolivia, Brazil, Chile, Costa Rica,

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108 The Wall Street Journal reported on 22 September 1988:

> In the small but growing market for Latin American bank debt, Chilean loans were priced yesterday at about 60 cents for each dollar of debt, bid, and 60.5 cents for each dollar for debt, offered. ... Until now, the only other Latin American Government that has bought back such debt in the open market is Bolivia, which purchased almost half of its $670 million foreign bank debt at 11 cents for the dollar earlier this year.

Wall Street Journal, (September 22, 1988) at 4 col 1.

109 Wallenstein & Silkenat, "Investment Funds and Debt-Equity Swaps: Broadening the Base of a New Financial Tool" (1988) 12 *Fordham International L J* 8 at 12.

110 Sperber, "Debt-Equity Swapping: Reconsidering Accounting Guidelines" (1988) 26 *Colombia J Transitional L* 377at 377ff.

Ecuador, Jamaica, Mexico, Nigeria, the Philippines, Uruguay and Venezuela.[111] While in the beginning the US commercial banks were reluctant to respond positively to these innovative suggestions, eventually they adopted a number of strategies to cope with the demand.

Debt-for-export swaps,[112] as the most recent development in dealing with external debt, came into existence in 1987, when the Peruvian government introduced this novel scheme into international business to ease its heavy debts.[113] This practice involves an arrangement whereby the creditor bank undertakes to import goods from the debtor country and to sell them in a given market. Subsequently, a portion, say 40 percent, of the money obtained through this process, will be used to service the loan and the surplus will be returned to the exporting country.[114] By using this program, the debtor country promotes its exports and consequently makes hard currency as well as reducing its debts. Moreover, in some cases the debtor country and creditor bank may enter into an agreement whereby the loan will be paid in goods rather than in cash.[115] Apart from private banks, many creditor countries have also agreed to accept products, technology, construction services, training in exchange for their debts. Under an arrangement between Russia and South Korea, for example, Russia is to pay off its debt to South Korea with military equipment.[116]

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111 French, "Conversion Funds? The Conception Was Quite Simple" (September 1987) *Euromoney* 107 at 110; Berkson, "Tax Implications of Debt-for-Equity Swaps" (1989) 12 *Hastings International & Comparative L Rev* 575.

112 It is also known as *debt-for-goods swaps.* Branton, "Limitations on Countertrade Agreements" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990 at 196.

113 Nisse, "Dogs or Cats?" (August 1987) *The Banker* 18 at 18.

114 More details about *debt-for-export swaps* in Chapter 8, pages 358-364.

115 For example, debt for bananas or debt for Brazilian biscuits. Evans, "New Debts for Old - And the Swapper is King" (September 1987) *Euromoney* 72 at 73.

116 XIV(24) *Countertrade & Offset* (December 23, 1996) at 6.

2.11. Mandated Countertrade

Mandated countertrade is an economic policy of a government to induce foreign exporters to undertake a countertrade commitment. This practice is closely connected to the intervention of a government in the marketplace encouraging imports to and exports from the country by means of countertrade. For many countries countertrade is a vehicle for developing the national economy, penetrating new markets, obtaining advanced technology and skills, correcting a trade deficit, enhancing defence capability and creating more employment opportunities.[117] To achieve such economic and social objectives, a government may use its legislative power or its massive economic strength to encourage or mandate countertrade directly or indirectly.[118]

By means of regulations, whether in the form of parliament acts or executive decrees, a country may make the imports of certain products or the imports in a specific sector conditional upon undertaking countertrade commitments. For example, the participation of foreign companies in infrastructure projects in Iran is permitted through countertrade schemes, so that the cost of project will be offset by the resultant products exported abroad.[119] In countries with exchange restrictions, hard currency may be provided to those importing traders which include a countertrade requirement in their offers.

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117 For the benefits and advantages of countertrade see Chapter 2.

118 Okoroafo has attempted to show the relationship between governmental mandating policies and four factors, namely the foreign exchange reserve, the debt service ratio, the commodity terms of trade ratio, and the balance of trade: i) the less the foreign exchange reserve of a given country is, the more its incentive to mandate countertrade; ii) whenever the debt service ratio rises, the need for bilateral arrangements seems more necessary; iii) if the average import price is more than the average export price, mandating countertrade is a way to sell the local products at higher prices in order to get access to more money; and iv) a country with a deficit in its import-export trade tries to correct the trade imbalance through mandating countertrade. Okoroafo, "Determinants of LDC Mandated Countertrade" (Winter 1988) 5 *International Marketing Rev* 16 at 16ff.

119 Law of the Second Plan of Economic, Social and Cultural Development of the Islamic Republic of Iran. (December 11, 1994).

Import licenses may be issued only for those importers undertaking a countertrade requirement. The products permitted to be imported may be classified into essential or non-essential products where countertrade may be required only for importation of those classified as non-essential. As an example of specific products which need a counter-export requirement, Ecuador has required its alcoholic beverage importers to achieve an equal value of banana exports.[120] In a number of countries the import for government procurement must be carried out through countertrade. Under a countertrade policy (Offsets Programs) in Australia, any imports for government purposes which exceed $2.5m must be offset by a 30% countertrade commitment.[121] The use of countertrade for government procurement, in either the civil or military sector, is widespread among almost all countries,[122] including the Western industrialised countries with the exception of the US which has recently taken an opposing position towards mandated countertrade even for military purposes.[123]

Countertrade policy in a country may be achieved by providing preferential treatment and facilities to those undertaking countertrade. The facilities offered to this end may in effect totally deprive other importers from access to the importing country's market. The facilities and preferential treatment given to those traders which undertake a countertrade commitment include administration assistance to enable those importers to get import licences more easily, information about the importing country's market, and materials about

120 Walsh, "Countertrade: Not Just for East-West any More" (1983) 17 *J World Trade L* 3 at 6.

121 Bureau of Industry Economics, *Monitoring of the Offsets Program* (Australian Government Publishing Service, Canberra, 1987) at 6.

122 During 1984, about 100 countries had some sort of countertrade mandating programs. Carey & Mclean, "The United States, Countertrade and Third World Trade" (1986) 20 *J World Trade L* 441 at 454.

123 "Offsets in Defense Trade" (1996) 117(9) *Business America* 155 at 157.

related regulations affecting the importer's success in the host country.[124] Above all, in some instances governments may provide a preferential tariff policy, tax relief, financial assistance and quotas to those traders importing goods under a countertrade scheme. Under a countertrade policy in India, for example, the imports of capital goods worth more than 200m Rupees are admitted duty-free if the importer undertakes to counter-export Indian products six times as much over eight years.[125]

A government as a large consumer may also use its economic strength to implement a countertrade policy through its state trading enterprises. The government may issue some informal guidance for their governmental agencies or enterprises to trade with those companies which include countertrade obligations in their offers. These informal orders are generally not regulated by legal documents nor are they publicised.[126] These informal recommendations put those trading partners which agree to undertake a countertrade obligation in a much better situation than their rivals.

It is worth mentioning that mandated countertrade is not a particular type of countertrade similar to other forms such as barter, buy-back or offsets. Mandated countertrade is a government program requiring importers to undertake a countertrade requirement, compared to voluntary countertrade programs which are entered into by private companies without government intervention. To comply with a countertrade requirement, the importer may be required to fulfil a specific type of countertrade like counterpurchase, buy-back or offsets. Since mandated countertrade is a unilateral requirement imposed by a government and is not subject to prior negotiation, it may violate several international regulations,

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124 Walsh, *Mandated Countertrade: Methods and* Issues (National Center for Export-Import Studies, Staff Paper #16, 1985) at 5-9.

125 XIII(11) *Countertrade Outlook* (June 12, 1995) at 2.

126 Lochner, "Guide to Countertrade and International Barter" (1985) 19 *International Lawyer* 731 at 739.

distort market forces, and adversely affect those foreign exporters which are not able to undertake such heavy countertrade demands. In fact, mandated countertrade is a concern to international institutions such as the WTO, IMF and OECD and is discussed in detail in Chapter 10.[127]

Conclusion

Countertrade is a term developed in the 1980s to identify a range of reciprocal and barter-like transactions. The use of other generic terms, such as barter, swap and offset, are still prevalent. Countertrade is a generic term which covers a broad range of transactions under which two sets of obligations on two opposing sides are legally linked to each other. There is no consensus about the transactions that fall into the category of countertrade. This chapter surveys the basic forms of countertrade with their definitions and distinguishing elements to establish a general ground for the coming discussions and analysis. The next chapter will examine the reasons why business people use countertrade.

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127 See Chapter 10: International Economic Law and Countertrade.

CHAPTER 2

Motivations for Countertrade

Introduction

A better understanding of countertrade requires a broad examination of the main reasons underlying its use. Since countertrade is a practice which has deviated from conventional money-based transactions, there should be specific objectives for the parties in choosing, encouraging or demanding countertrade in international trade, abandoning conventional deals. The Argentinian Vice-President stated the purposes of his country's countertrade policy as follows:

> To increase the levels of exportation; to open new markets; to facilitate the promotion of those Argentinian products which have a difficult access to international markets; to use the external purchasing power of the Nation as a whole and the State in particular as a means to permit and favour the country's exports and to induce a rational utilisation of the instruments of foreign payments. This demands the exploration of new concepts and practices in international trade, including establishment of a mechanism which enables commercial exchange without transfer of foreign currency or under its minimal transfer.[1]

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1 The Preamble to the Argentina's Decree No 176/85, 25 January 1985. Rajski, "International Compensation Trade Transactions" in Sarcevic (ed), *International Contracts and Conflicts of Laws* (Graham & Trotman, London, 1990) at 105.

A report evaluating the offset programs in Australia concluded that "the primary objective of the Offsets Program is to improve Australian infrastructure by bringing to industry advanced technologies, skills or capabilities which will lead to the establishment or enhancement of internationally competitive activities within Australia".[2] These two examples show that countertrade is used to achieve certain objectives which may vary from case to case. One reason alone rarely accounts for a party entering into a countertrade transaction. The major motivations could be classified into the following groups: exports promotion; marketing tools; financing imports and projects; access to hard currency; making a balance of trade; access to technology; securing supplies of raw materials; political objectives; and overcoming trade barriers and non-favoured regulations.

1. Export Promotion

One of the main reasons underlying the use of countertrade is to develop exports and to penetrate international markets. Increased exports accelerate the development growth of a country, create hard currency, correct its balance of payments deficit, and improve the living standards of its citizens.[3] In spite of these advantages, many countries, particularly in the developing world, have problems in entering international markets either because of trade restrictions in the developed countries' markets or because of a lack of marketing knowledge, skill or established marketing networks. To access international markets, one needs to present goods acceptable to consumers in terms of quality, packaging, taste, after-sales services and price. Products should be introduced to the consumers through

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2 Bureau of Industry Economics, *Monitoring of the Offsets Program* (Australian Government Publishing Service, Canberra, 1987) at 31.

3 For an economic theory which shows the effects of exports on economic growth, see Helleiner, *International Trade & Economic Development* (Penguin Books, Middlesex, England, 1972).

advertising and distributed through a reliable marketing network. Those countries which have limited market capacity and experience view countertrade as a way to promote their exports by shifting the responsibility of marketing to the exporting partners. Two groups of countries use countertrade to expand their share of world markets: i) countries that produce primary products such as oil, minerals, sugar and cocoa; and ii) developing countries with advanced technical capacities that produce semi-manufactured or manufactured products such as computers, television receivers or telecommunications equipment.[4]

1.1. Marketing Primary Goods

It is important for those countries producing primary commodities to maintain the market when their goods are suffering from low prices, over-production or stagnant markets. In these circumstances, they need to maintain a guaranteed future market for their goods at a reasonable price. One efficient method to export primary products in such circumstances is the utilisation of countertrade transactions. By demanding countertrade, the producer of primary products encourages its trading partner to purchase from the producer.[5] This method helps the producer to maintain its exports or to create new market opportunities for its products. Zimbabwe, for example, has viewed countertrade as a method to increase the export of its primary products.[6] Moreover, owing to an urgent situation such as war, political instability or the need to develop long-term plans, a producer of primary products may need to increase its share in the global market in spite of a saturated market. One

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4 It should be noted that certain countries may fall into both categories. A country maintaining its traditional market of primary goods may also attempt to export semi-processed or manufactured products to international markets.

5 According to the US International Trade Commission, the most important commodities imported to US under countertrade arrangements are bauxite and iron ore. OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 18.

6 Page, *How Developing Countries Trade* (Routledge, London, 1994) at 81.

technique to achieve that end is to pay the exporting partners in primary products such as oil, copper or bauxite.

In some cases, countertrade has been used as a method for disposing of surplus commodities without damaging their world prices. While both the US and the European Community have faced surpluses in agricultural products, they are reluctant to dispose of them at below their normal prices.[7] In situations where selling the products in the world marketplace may have an adverse effect on prices and a decline in production causes negative consequences, countertrade may be of assistance to export the goods in exchange for other products to countries suffering from a hard currency shortage. For example, the US used countertrade to export agricultural products to Jamaica, avoiding the negative consequences of the exports on their market prices.[8] Sometimes countertrade is used to promote exports without damaging the established (traditional) markets a country has. An exporting partner may impose certain restrictions upon the resale process or require that the countertraded goods be used for internal consumption. Barter and counterpurchase are the two forms of countertrade most frequently used for the disposal of primary products in the world market.

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7 According to the OECD report, the reasons for the engagement of a large European food producer, having 280 factories in 55 different countries, in countertrade transactions includes: maintaining its market share, developing new markets, facilitating payment of dividends, and creating a favourable business environment. OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 20.

8 See Lee, "Bauxite for Butter: The US Jamaican Agreement and the Future of Barter in US Trade Policy" (1984) 16 *Law & Policy in International Business* 239.

1.2. Marketing of Manufactured Goods

The marketing difficulties for those producing semi-manufactured or finished goods are to some extent different to the producers of primary goods. Many countries attempt to reduce their reliance upon the export of primary products by shifting to the exports of semi-processed and manufactured products. Selling these products through international markets is not easy because they may be poor in quality, not consistent with a given market's demands, unattractive in packaging and appearance, or lack the support of a good brand name or after-sales service. Moreover, many countries impose certain protectionist measures on the import of such products which affect a party's ability to enter into their markets. As a result, the countries with an economic capacity to produce finished or semi-finished products view countertrade as a pathway through these barriers and difficulties.[9] For example, the newly industrialising countries in South-East Asia have adopted countertrade policies to promote their exports of manufactured and semi-manufactured products.[10] Countertrade has been considered by these producers as a means of gaining access to a marketing network, improving the quality of the goods they produce and overcoming the barriers imposed in the destination countries.

The lack of an established marketing network is one the main obstacles in the way of a country to the world market. Countries with marginal production capacity often seek the marketing services of large firms in the US, Europe and Japan which have advanced and extensive distribution networks. It may be more desirable for a country with a small production capacity to demand a countertrade requirement to sell its products abroad rather

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9 Weigand, "Apricots for Ammonia: Barter, Clearing, Switching, and Compensation in International Business" (Fall 1979) XXII(1) *California Management Rev* 33 at 39.

10 Sender, "The Booming World of Countertrade" (January, 1984) 123 *Dun's Business Month* 76 at 78.

than to enter into an agreement with several companies to use their marketing services and networks. These countries prefer to present a list of semi-manufactured or manufactured products to their trading partners, requesting them to counter-export them as a condition for doing business. The responsibility of finding appropriate marketing networks is shifted to the exporting partner through countertrade.[11]

Producers in the developing countries or in the transitional market economies[12] may lack the advanced technology and skill to manufacture products of a quality which can compete in international markets. One method to export these products is to request the trading partners to counter-export them to be disposed of in a suitable marketplace. Alternatively, the poor quality products may be bundled together with other more desirable products under a countertrade deal to be sold jointly at a discount.[13] In some cases, trading partners with advanced technology have helped the producer to improve the quality of the products to make them more marketable in a given market. For example, the Coca Cola company and Yugoslavia engaged in a countertrade arrangement under which Coca Cola agreed to market Yugoslavian wine in the US. Since the taste of the wine was not acceptable to the US consumers and the design of bottles was unattractive, Coca Cola provided some assistance to grape producers to improve the taste of the wine and to redesign the bottles.[14]

Countertrade may also be used to overcome the trade barriers imposed by countries to protect their industries from foreign competitors. These protective measures include a wide range of measures from tariffs and quota to non-tariff barriers. Although the WTO

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11 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 9.

12 The transitional market economies are the centrally-planned countries which belonged to the socialist block.

13 Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 78.

14 Mishkin, "Countertrade I" (1989) *International Business Lawyer* 402 at 403.

(previously the GATT) aims at liberalising trade amongst contracting parties and to some extent has been successful in eliminating or reducing tariffs, non-tariff barriers are still the main obstacles to greater trade liberalisation.[15] Non-tariff barriers include a wide variety of measures which directly or indirectly keep foreign competitors from entering a given market. These measures include quotas, sanitary controls, labelling requirements, standardisation, restrictions on purchases of foreign goods, and discriminatory government procurements.[16] By means of countertrade, a producer lacking the ability to produce goods to safety and health standard requirements can involve its trading partners in the production process to produce goods which will meet these requirements.[17] Moreover, the packaging and labelling requirements[18] can also be met by shifting the responsibility of the labelling and packaging of products to a trading partner under a countertrade arrangement. Under buy-back agreements, for example, the goods are often produced under the surveillance of the exporter of technology and equipment so as to ensure that the resultant output meets the marketing demands and expectations.

Another non-tariff barrier is that governments, as a major purchaser, use their consumer strength to purchase from domestic or certain foreign producers on a discriminatory basis.[19] While the GATT has been established on the principle of non-discrimination, Article III 8(a)

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15 The Uruguay Round has achieved some success in dealing with non-tariff barriers in the areas of agriculture, textiles and safeguards. Amjadi & Yeats, "Non-tariff Barriers Facing Africa: The Uruguay Round" (1995) 63 *South African Journal of Economics* 384 at 391.

16 Page, *How Developing Countries Trade* (Routledge, London, 1994) at 40.

17 As an example, some countries require every imported beer to contain certain types of ingredients and specific key components. Carbaugh, *International Economics*, (Wadsworth Publishing Company, California, 4th ed 1992) at 170.

18 In Canada, for example, the canned goods being imported to the country must match certain container sizes. As above.

19 For example, in 1991 US Government agencies purchased 22 percent of the goods and services which were produced internally. Carbaugh, *International Economics*, (Wadsworth Publishing Company, California, 4th ed 1992) at 169.

of the GATT 1994 excludes government purchases from that principle.[20] One method to gain access to these government-purchase markets is to utilise countertrade arrangements. By requiring and mandating countertrade commitments, one producer may induce these State-trading partners to purchase a proportion of their purchases from the producer if they want to export to the country demanding countertrade.

In sum, lack of experience and skill in international marketing and the lack of an established marketing network and reputation induce many developing countries and transitional market economies to use, encourage or demand countertrade arrangements as a marketing tool to shift the responsibility of marketing to their trading partners in order to export and to set up a reputation for their products. The exporting partners undertake counter-purchase demands as a competitive tool in order not to lose their markets in the countries requesting countertrade.

2. Countertrade as a Competitive Tool

As discussed above, many countries, particularly in the developing world or in transitional market economies, request their exporting partners to include countertrade undertakings in their exporting offers. Why do these exporting companies, often based in industrialised countries, agree to counter-export or to undertake other countertrade commitments? These exporting companies may be against such requirements in principle, looking on countertrade as a nuisance in today's international business. Nevertheless, if doing business depends on a

20 The WTO Government Procurement Agreement extends the most-favoured nation and national treatment principles to government purchases. Nevertheless, the Agreement does not cover the whole of government purchases, nor is it applicable to all WTO members. It is only effective for its signatories. For more details see Chapter 10, pages 413-435.

positive response to countertrade demands, they may view countertrade as a marketing tool to win a deal. For these exporters, undertaking countertrade commitments may be a right response to circumstances where rejecting countertrade demands excludes them from the market. As a result, their engagement in countertrade is to maintain or extend their markets in the countries demanding countertrade. A senior officer in the Trade Department of Sweden outlining his country's position on countertrade said:

> Sweden's position could perhaps be characterised as negative in principle but realistic enough to realise that also pragmatism has to play a part when treating countertrade techniques. ... The reason is that we have to recognise that countertrade offers and capacities are important parameters of competition for individual companies in specific markets. To the extent that competition among companies is determined by countertrade capability our official view has to be influenced by our interest in supporting our companies sales efforts. In such circumstances our pragmatic view may be that although countertrade is fundamentally wrong, Swedish companies are by far best at it.[21]

Those firms which were slow in responding to countertrade demands have realised that they have been excluded from specific markets because of their unwillingness to include countertrade undertakings in their offers.[22] Having realised the importance of countertrade in certain markets, they began to respond to countertrade demands more sympathetically in order to maintain their established market that might otherwise be won by someone else. McDonnell Douglas, for example, won a $2.4 billion sale over General Dynamics, because of its more generous offset terms offered to the Canadian Government.[23] In another example, "McDonnell Douglas' T-45 Goshawk Trainer aircraft has been disqualified for Australia's trainer procurement due to disagreements over offsets and price".[24] These two

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21 Stalberg, "Techniques of Countertrade - The Official Position of a Government" in ICC, *Countertrade: Offset Contracts* (ICC, Paris, 1994) at 60-61.

22 According to a survey of large British companies, 29% of respondents stated that they had previously lost worthwhile foreign business because they showed no interest in engaging in countertrade with new customers. This survey also shows that 80% of the respondents indicated that their main rivals did engage in countertrade. Shipley & Neale, "Industrial Barter and Countertrade" (1987) 16 *Industrial Marketing Management* 1 at 4.

23 Welt, "Military Offsets" (March 1984) 396 *National Defense* 20 at 21.

24 XIV(23) *Countertrade & Offset* (December 9, 1996) at 8.

examples show that a failure to respond appropriately to a countertrade demand may result in losing the deal.

Exporting firms should be aware of the fact that countertrade is a reality in today's international trade and rejecting a countertrade demand may deprive them of a market. The demand for countertrade is growing in aerospace, electronics, automobiles and defence industries, which require major capital.[25] Those firms which include countertrade obligations in their offers or those offering more favourable countertrade terms may enhance their positions vis-a-vis their competitors in these areas. Mr Christensen from Goodyear, a major US tyre manufacturer, said: "We trade our tires for minerals, textiles, agricultural products, almost anything. If we don't, they'll get (tires) from somebody else. They aren't going to drive their cars on the rims."[26] In a further development, some Western firms have initiated the offer of countertrade packages to their trading partners, having difficulties purchasing in cash, in order to export. Innovative countertrade techniques have been proposed by Western firms as a way out of the difficulties which restrict their business in particular markets.[27] The debt-for-export swaps, for example, have been proposed by the US banks to overcome the financial difficulties of certain Latin American countries.[28]

In addition to maintaining exports and winning a deal, undertaking countertrade obligations in the form of buy-back or offsets may also help manufacturing firms to produce certain

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25 Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 37; OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 20.

26 Martin & Ricks, "Countertrade Grows as Cash-short Nations Seek Marketing Help" (March 13, 1985) *Wall Street Journal* at 1, col 1.

27 For instance, in the early 1980s when Latin American countries faced with debt crisis, some multinational companies in the US proposed innovative countertrade mechanisms to be able to continue their sale to these countries. OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 20.

28 See Chapter 1, page 48 and Chapter 8, pages 358-364.

products abroad using cheap labour and abundant raw materials. Manufacturing products cheaper improves the trading positions of the producer in relation to its competitors. For example, IBM is producing a number of its computer parts in Malaysia, India or Singapore to reduce the costs of the computers so as to provide competitive prices to its customers.[29] One way to take advantage of cheaper labour is to produce certain products or some components within the territory of a developing country under a buy-back or offset scheme.

Using countertrade as a competitive marketing tool, a number of Western exporting firms are becoming involved in it as a means of showing their good faith to their trading partners in order to establish a long-term relationship.[30] Such a positive response from the exporting firms occurs when there is either an extensive trade relation with a party demanding countertrade or a landscape for such a relation in future. Undertaking countertrade obligations is viewed by these firms as a strategy to set up a long-term relationship in a given market, rather than considering its immediate benefits or costs. George Stathakis, the president of General Electric Trading Company, said: "We look at it [countertrade] as an opportunity to enhance our reputation for reliability."[31] Due to this policy, General Electric countertrade operations have grown from $80 million to around $4 billion over a short span of time.[32]

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29 It was estimated that the manufacturing cost of an IBM PC was $860 in 1985. Out of that amount $232 was attributed to the US-owned plants, $85 to South Korea, $165 to Singapore and the rest to Japan. Carbaugh, *International Economics*, (Wadsworth Publishing Company, California, 4th ed 1992) at 10.

30 A foreign trade adviser at Austria's Die Erste Bank said: "Trading with the COMECON is a longer-term business. You don't just go in and make a quick profit, you have to keep at it for years. But once you have established yourself and built up confidence, you can make good money." Blum, "Viennese Traders Are Reaping Benefits from Barter Trade" (April 5, 1984) *Financial Times* at 4.

31 Martin & Ricks, "Countertrade Grows as Cash-short Nations Seek Marketing Help" (March 13, 1985) *Wall Street Journal* at 1, col 1.

32 Welt, "Countertrade as a Competitive Tool" (January 1986) 75 *Management Rev* 53 at 54.

As a result, undertaking countertrade commitments is part of the marketing strategy of many companies to do business abroad. Countertrade is a marketing tool for them to enter into otherwise inaccessible markets, to maintain their marketing shares, to produce cheaper products, or to establish a long-term relationship.

3. Financing Imports and Projects

One of the most significant and complex aspects of international business is trade financing. To be able to import goods or to set up a project using international materials and services, one needs to arrange payment in a convertible currency. Many nations, particularly in the developing world, suffer from a hard currency shortage. They may be reluctant to place further pressure on their hard currency reserves or to borrow from international financial institutions in order to import. Sometimes an unexpected change in the price of a commodity contributes to disrupting the financial position of a country. For example, when in the mid 1970s oil prices rocketed, many oil-importing countries faced a sharp deficit in their international payments. The 1980s witnessed the rapid growth of countertrade as a form of financing imports and construction projects.[33] The following is a discussion of how countertrade may be used as a financial tool to support imports of goods and services or to finance projects.

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33 Santamaria, "Countertrade" in Horn (ed), *The Law of International Trade Finance* (Kluwer, the Netherlands, 1989) at 40.

3.1. Financing Imports

When a country is in financial difficulty, it may wish to put restrictions on transferring hard currency abroad. The government may restrict hard currency payments to a list of products which are to be imported. In such countries local currencies are often over-valued, inconvertible or under the tight control of the authorities. In these circumstances, while there is no direct restriction on imports, financing them is a problem. One way out of the problem is to use reciprocal deals under which the costs of imports are to be compensated through exports. The products to be imported may be traded in exchange for certain products to be counter-exported under a countertrade transaction. For example, the sale of seven US helicopters, valued at $30m, to the Slovenian Defence Ministry has been entirely financed through countertrade.[34] Alternatively, two countries may establish a clearing arrangement whereby two parties exchange products of up to a specific amount without any hard currency transfer.[35] When a party has no money to buy, the seller is in a dilemma; either abandon the deal or undertake counter-exports to generate hard currency for its own exports. According to one business report, for example, most imports to Turkmenistan from the West are financed by countertrade.[36] In a number of situations doing business, even with a countertrade commitment, is preferable to losing the market.

3.2. Financing Major Projects

In many countries the burden of financing infrastructure projects is too heavy for governments to bear. Although they have to spend a huge amount of hard currency to build

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34 *International Trade Finance* (June 17, 1994); available in Lexis-Nexis, News Library.
35 See Chapter 1, pages 33-37.
36 XIII(15) *Countertrade Outlook* (August 14, 1995) at 3.

infrastructure and other costly projects which are necessary for the country's development, hard currency reserves are under pressure. Countertrade is increasingly viewed as a means of project financing to inflow foreign capital, avoiding the consequences of direct investment or the danger of accumulating long-term debts.[37] In 1979, for example, Australia agreed to construct six 200-room prefabricated hotels in exchange for China's frozen and canned food.[38] Countertrade arrangements in the form of buy-backs, offsets or BOT are attractive to many countries keen to develop infrastructure plans as a mechanism to transfer the financial burden of construction to foreign trading partners. In China, for example, many schemes such as dams, power plants, highways, railways, subways and telecommunications are to be financed through countertrade deals.[39]

4. Access to Hard Currency

Foreign companies may face a problem in getting their money back in a convertible currency due to a shortage of hard currency or currency exchange restrictions. The money may be the price of goods or services sold, loans, royalties, dividends, licensing fees, or local earnings. The money may be either in hard currency which is inaccessible because of a hard currency shortage or in local currency which is inconvertible because of foreign exchange controls. One way out of the problem is to use countertrade to take the money out of the country in hard currency. Countertrade may be used to pay off the outstanding debts or to convert blocked funds into hard currency.

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37 Duval, "Regulatory and Contractual Aspects of a Countertrade Agreement" in ICC, *Countertrade: Offset Contracts* (ICC, Paris, 1989) at 10.

38 Price, *Financing International Projects* (International Labour Organisation, Geneva, 1995) at 110.

39 Dodds, "Offsets in Chinese Government Procurement: The Partially Open Door" (1995) 26 *Law & Policy in International Business* 1119 at 1119ff.

4.1. Paying off the Outstanding Debts

Many developing nations in Latin America, Asia, Africa and the Middle East, which have borrowed huge amounts of money, have failed to meet their repayment obligations.[40] They have faced serious problems in servicing the continuously increasing debts. Since they have to allocate some of their hard currency earned to import essential products, there is insufficient hard currency to service the loans.[41] In these circumstances, countertrade arrangements can play a role in relieving the debt burden of these nations without having a negative effect on their domestic economies. One method is to pay the debtors in products which helps the country to pay its debt through further exports. For example, some oil-producing countries such as Iraq,[42] Iran,[43] Libya, Qatar, Kuwait and Nigeria have requested that their creditors be paid in oil.[44] Russia is keen to pay off the debt of the former Soviet Union to various creditors with deliveries of industrial products or military equipment.[45] Under another variation, the creditor agrees to export a specific quantity of the debtor's products abroad to be sold through its facilities in international markets. A specific percentage of the export proceedings is to be allocated to service the debt and the rest to be

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40 According to a recent OECD report, the foreign debt of third world countries increased in 1994. The foreign debts of developing countries increased to $1714 billion in 1994 compared with $1570 billion at the end of the previous year. The OECD report added that the ten countries with the greatest increase in debt were Thailand, China, South Korea, Mexico, Indonesia, Argentina, the Philippines, India, Israel, and Former USSR. OECD, *External Debt Statistics* (OECD, Paris, 1995) at 7.

41 Welt, "Countertrade as a Competitive Tool" (1986) 75 *Management Rev* 53 at 53.

42 For instance, in 1989 Iraq paid DM400 millions out of its DM1.4 billions debt to the Germany in oil. Wulker-Mirbach, "New Trends in Countertrade" (April-May 1990) 163 *OECD Observer* 13 at 16.

43 Iran paid off $30m of its $43m debt to Romania in oil. XV(5) *Countertrade & Offsets* (March 10, 1997) at 7.

44 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 15.

45 An agreement has been reached between Russia and South Korea to pay off $1.2b debt of South Korea with military equipment. XIV(24) *Countertrade & Offsets* (December 23, 1996) at 6. Hungary has also agreed to be repaid by military pieces and hardware. XIV(23) *Countertrade & Offsets* (December 9, 1996) at 4.

given to the debtor. In October 1987, for example, Midland Bank agreed to sell $22 million worth of Peruvian products, including iron pellets, fishmeal, steel balls, coffee and copper wire, taking $8.8 million for debt servicing and returning the rest to the Peruvian partner.[46]

4.2. Converting Blocked Funds

In some cases, the revenue of a foreign company is in local currency which is inconvertible to hard currency or the transfer of which is under severe control. The local currency may be converted to hard currency by way of countertrade.[47] When the funds are blocked in a country, they may be used to purchase local products to be exported and sold in international markets against hard currency. Through this practice, the foreign company takes its money out of the country in hard currency and the country benefits by promoting its exports. Alternatively, the blocked funds may be transferred at a discount to an investor company interested in investing in the country. This practice which is known as debt-for-equity swaps[48] benefits not only the investor, who gains access to a discounted local currency needed for investment, but also the owner of the funds who gets back its money in hard currency.

Another way to convert the blocked funds into hard currency to get them outside the country is to use them to produce valuable things to be exported to world markets. For example, the local currency may be used in a project that could lead to the production of an intangible property to be exported and sold in the world marketplace in hard currency. The project may lead to the production of movies, computer programs, formula for new

46 Wulker-Mirbach, "New Trends in Countertrade" (April-May 1990) 163 *OECD Observer* 13 at 16.
47 Welt, "Untying Those Blocked Funds" (May 1987) *Euromoney* 277 at 277.
48 See Chapter 1, page 47.

medicines, or other intellectual properties. Pepsico, for example, used its blocked currencies in Hungary to produce a movie there. As a result, the movie, *the Ninth Configuration* was successfully produced and sold outside Hungary for hard currency.[49] In addition to Hungary, blocked funds have been used in Pakistan, Mexico, Egypt, India, Argentina, Greece, Romania, Yugoslavia and Brazil to produce movies.[50]

5. Making a Balance of Trade

The difference in value between a country's imports and exports constitutes its balance of trade. If the exports from the country exceed its imports, the country has a trade surplus and if the imports exceed exports, a trade deficit exists. A country experiencing a trade deficit may want to correct its balance of trade through a countertrade policy. For instance, the reasons underlying the recent rise in Egypt's countertrade demands, as Abdel-Latif remarks, are: i) the need for substantial imports for a large population and development plans; ii) little increase in exports compared with the rapid rise in imports: iii) traditional dependence on exporting certain primary commodities; and iv) allocation of considerable amounts of revenue to debt servicing.[51]

Through implementing a countertrade policy, a country may want to achieve a trade balance with those countries with which a trade deficit exits. Brazil, for example, declared in May 1984 that it would decrease its oil imports from those suppliers that have not purchased

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49 Weigand, "Barters and Buy-backs: Let Western Firms Beware" (November-December 1980) 23 *Business Horizons* 54 at 55.

50 Barkas, "A Bank's Role in Facilitating and Financing Countertrade" in Korth (ed), *International Countertrade* (Quorum Books, New York, 1987) at 78; Welt, "Untying Those Blocked Funds" (May 1987) *Euromoney* 277 at 277.

51 In the period 1972-1981, one-fifth of Egypt's export revenue was allocated for servicing debts. Abdel-Latif, "The Egyptian Experience with Countertrade: Case Studies" (1990) 24 *Journal of World Trade* 17 at 20-21.

enough Brazilin goods.[52] A countertrade policy may also be implemented to speed exports and to limit imports. The use of countertrade to promote exports has been discussed above.[53] In conclusion, countertrade may be used to limit the flow of imports to the country.

In some instances, a country declares a policy under which imports of certain products or for a specific sector must be matched with counter-exports of equal value. Ecuador, for example, required alcoholic beverage importers to export an equal value of bananas.[54] If foreign trading companies are less likely to export under countertrade schemes, the inflow of imports to the country could slow down. Import licences may be issued only for those exporting firms which agree to undertake a countertrade undertaking.[55] Or State-owned enterprises may buy from those firms which include countertrade undertakings in their offers. The more rigid the countertrade requirements, the less opportunity to import. The list of products or the sectors which need to meet countertrade obligations vary from a country to country in accordance with the countertrade policy of that country. Since by mandating or requesting countertrade obligations as a condition for imports the volume of imports can be controlled, the Western trading partners view such measures as non-tariff barriers.[56]

Since the balance of trade is part of the balance of payments, countertrade may also help a country to improve its balance of payments. The following hypothetical example may clarify how countertrade could help an indebted country to save money. Suppose Brazil has

52 De Miramon, "Countertrade: An Illusory Solution" (May 1985) 134 *OECD Observer* 24 at 25; OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 17.

53 See above, pages 54-60.

54 Walsh, "Countertrade: Not Just for East-West Any More", (1983) 17 *J World Trade L* 3 at 6.

55 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 15.

56 Stevenson, "Hurdling Nontariff Barriers" (August 31, 1982) *New York Times* at 21, col 1.

a debt which forces it to allocate a considerable portion of its export revenue to service the debt, while it has to import certain products in any event.[57] Due to its hard currency shortage, Brazil wants to import necessities without using its hard currency reserves or creating new debts. To achieve that end, Brazil may negotiate with Iran to buy oil under a countertrade mechanism.[58] The two countries may agree on a clearing account under which each country can import up to $100 million worth of the other country's products over a year. By means of this arrangement, Brazil may import up to $100m worth of oil without using hard currency or increasing any new debt.

Alternatively, the two countries may select a barter deal whereby a certain amount of oil is to be exchanged for Brazilian manufactured products. The use of barter enables Brazil to import oil without paying hard currency. In another option, Brazil and Iran may agree on a counterpurchase arrangement whereby Brazil imports oil on the condition that Iran undertakes to buy an equal value of Brazilian products. Although in this option, Brazil has to pay the oil price first, the amount paid by Brazil will eventually be offset when Iran implements its counter-purchase undertaking. In addition to the clearing arrangements, barter and counterpurchase, if Brazil has already bought oil from Iran and is not able to pay its debt, Brazil may ask Iran if it can accept payment in products rather than cash. While these are the main forms of countertrade, other types may also be used to improve the financial position of a country suffering from a deficit in external payments.

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57 Brazil at one stage was spending more than half of the hard currencies obtained through exports on debt servicing. Welt, "Countertrade as a Competitive Tool" (January 1986) 75 *Management Rev* 53 at 53.

58 In May 1984 Brazil announced a countertrade policy under which all oil imports would be purchased through countertrade. A OECD report in 1984 said that half of the oil imported to Brazil was compensated by supplying food and manufactured products to oil producers under various countertrade schemes. Carey & McLean, "The United States, Countertrade, and Third World Trade" (1986) 20 *J World Trade L* 441 at 459.

6. Access To Technology

A Ministerial statement of 15 January 1986 in Australia said the objectives of offset programs are to:

> bring to Australian industry advanced technology, skills and capabilities to meet the goals of:
> (i) establishing internationally competitive activities within Australia; and
> (ii) supporting defence industry capability objectives.[59]

There is an increasing demand for technology and advanced technical innovation in science, medicine, communications, aerospace and defence related equipment, especially from developing countries.[60] Many countries are struggling to acquire advanced technology from industrialised countries to promote local industries, improve living standards, create more employment opportunities, and make their products internationally competitive. The World Intellectual Property Organisation has defined technology as follows:

> Technology means systematic knowledge for the manufacture of a product, the application of a process or the rendering of a service, whether that knowledge be reflected in an invention, and industrial design, a utility model or a new plant variety, or in technical information of skills, or in the services and assistance provided by experts for the design, installation, operation or maintenance of an industrial plant or for the management of an industrial or commercial enterprise or its activities.[61]

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59 Bureau of Industry Economics, *Monitoring of the Offsets Program* (Australian Government Publishing Service, Canberra, 1987) at 5.

60 Since the 1970s developing countries have decided to be involved more effectively in the international economic system. They argue that the international community needs a *New International Economic Order* to enhance their economic growth. They pushed for a modification in the international economic structure whereby advanced countries should accept more responsibility in making new policies to the benefit of developing countries. Under the *New International Economic Order*, it has been expected that some preferential measures should be given to developing countries with respect to their exports to developing countries markets and their needs for technology transfer so as to narrow the gap between developed and developing nations. For these countries one place to express their concerns is the UNCTAD forum. While the struggles made under the UNCTAD have led to certain tariff concessions for developing countries to export their commodities to developed countries markets, the overall success has been modest. Carbaugh, *International Economics* (Wadsworth Publishing Company, California, 4th ed 1992) at 208; Jackson, *International Economic Relations* (West Publishing Co, USA, 1986) at 1168.

61 World Intellectual Property Organisation, *Licensing Guide for Developing Countries* (WIPO publication, Geneva, 1977) at 28.

Technology transfer, therefore, includes providing technical assistance, training personnel, collaboration in research, granting licences, transfer of patents, and supply of machinery and equipment to a country. While the acquisition of technology is rightly perceived by less developed countries as a vital step towards economic growth,[62] there are a number of difficulties preventing these countries acquiring advanced technology. The unavailability of skilled labour and financial resources in the country demanding technology on one hand, and the unwillingness of developed countries in speeding up the process of technology transfer on the other hand,[63] induce many countries to use countertrade as a mechanism to acquire advanced technology.[64]

Countertrade in the form of buy-back, offsets or Build-Operate-Transfer (BOT) is a vehicle to induce trading partners to transfer the advanced technology, know-how, patents and skills to the country. By means of countertrade, a country not only obtains technology but also places no further pressure on its reserves, since the projects are to be financed by the owner of technology or the costs are to be compensated by counter-exports. The use of buy-back to obtain new technology and to advance scientific progress has been initiated by centrally-planned countries to overcome the barriers to their industrialisation.[65] China, for

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62 Several major studies carried out in the US show that technological changes have a direct impact on economic growth. Karake, "Technology Transfer and Economic Growth in the Less Developed Countries" in Chatterji (ed), *Technology Transfer in the Developing Countries* (Macmillan, London, 1990) at 104.

63 For example, for high-technology transfer, the *Coordinating Committee on Multilateral Export Controls* has been established by the NATO countries plus Japan to administer a uniform practice in relation to control of high-technology transfer to other countries. Siddiqi, "Factors Influencing the Transfer of High Technology to the Developing Countries" in Chatterji (ed), *Technology Transfer in the Developing Countries* (Macmillan, London, 1990) at 155.

64 Technology may also be acquired through other mechanisms like i) straightforward purchases of equipment, patent and know-how; ii) utilisation of license agreements; iii) establishment of joint ventures; and iv) acquisition of equity shares in a subsidiary which uses the technology.

65 Pepsico, for example, entered into a countertrade agreement with the former Soviet Union whereby Pepsico undertook to build soft drink factories as a condition of its supplying of the syrup. Pepsico's aid included training of workers, assistance in the engineering, design, and construction of the factories, and assistance in producing new bottles for Soviet vodka (a screw-on top with a new label). Welt, "Unconventional Forms of Financing: Buy-Back/ Compensation/ Barter" (1990) 22 *New York Uni International L & Politics* 461 at 466.

example, has entered into various buy-back arrangements as a means of acquiring technical knowledge and up-to-date machinery to enhance economic growth.[66] In this regard, one European businessman said: "It's a fact of life these days that if you want to do business with China, you must give away some of your technology".[67] The use of buy-back to gain access to technology in order to industrialise the country or to upgrade manufacturing capacities is now widespread. For example, technology-transfer is one of the major objectives of countertrade demands in South-East Asia.[68] The result of a recent study undertaken by the International Committee of US Electronic Industries Association shows that out of ten countries in the region, nine countries demand technology-transfer under offset requirements.[69]

The use of countertrade for technology acquisition between developed countries has generally taken place in the form of offsets, particularly in military related industries. Among developed countries, Canada has a leading position in the development of the offset policy as an industrial growth tool.[70] For example under a $2.37 billion deal, a US aerospace firm agreed with Canada to hire Canadian subcontractors, to transfer aerospace technology to Canadian firms and to promote the Canadian tourist industry. The technology required to be transferred to Canada included information for the production of

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66 Under a countertrade arrangement Container Transport International (CTI) undertook to build a container manufacturing factory in China; in return, CTI agreed to purchase back a specific number of containers produced in the plant. Guyot, "Countertrade Contracts in International Business" (1986) 20 *International Lawyer* 921 at 956.

67 "China Increasingly Linking Imports to Technology Transfer" (May, 1989) *World Policy Guide;* available in Lexis-Nexis, Business News Library.

68 Shanson, "Building on Offsets" (December 15, 1990) 14(24) *Jane's Defence Weekly* at 1248.

69 These nine countries are Japan, South Korea, Taiwan, Australia, Brunei, Indonesia, Malaysia, the Philippines and Thailand. XV(1) *Countertrade & Offsets* (January 13, 1997) at 5-6.

70 XIII(10) *Countertrade Outlook* (May 22, 1995) at 1-4.

advanced composite materials, cruise missile navigation equipment, fibre optics, and technology involving computer-aided design.[71]

7. Securing Supplies of Raw Materials

Another motivation for countertrade is to ensure a flow of inexpensive raw materials, intermediate goods and energy into the country. The steady flow of certain raw materials to a country may be perceived as strategic for defence or economic objectives. Countertrade allows a party to obtain a long-term reliable supply of raw materials. Dr Jung Sun Suh, the director of the Daewoo Research Institute in South Korea, explaining the reasons for the engagement of Korea in countertrade with China, said: "We need silk, coal, copper, iron ore and raw materials."[72] The Algerian government views countertrade as a tool to obtain raw materials like copper, lead and zinc from Zambia, and to import agricultural products from Tanzania and coffee and cocoa from Colombia.[73]

Countertrade is a useful means by which Japanese firms routinely search for the lowest-cost supplies of raw materials.[74] They view countertrade as a way of securing a stable import of essential raw materials, especially oil and iron ore.[75] A survey of 104 countertrade transactions entered into by Japanese companies during 1987, 1988 and the first half of 1989 shows that the majority of goods imported to Japan under countertrade schemes were

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71 McVey, "Countertrade: Commercial Practices, Legal Issues and Policy Dilemmas" (1984) 16 *Law & Policy International Business* 1 *at* 13.

72 Montagnon, "Seoul Uses Olympics as Trade Springboard" (June 21, 1988) *Financial Times* at 7.

73 "Countertrade in Algeria: A Necessary But Risky Business" (January 1987) 10(1) *Middle East Executive Reports* 9 at 12.

74 Yoffie, "Profiting from Countertrade" (May-June 1984) *Harvard Business Rev* 8 at 10.

75 Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 32.

industrial raw materials.[76] Through countertrade Japan maintains an assured supply of low-cost raw materials, stabilising their inflow to the country. Because of Japan's success, many US and European firms rely on the experience and knowledge of Japanese firms in dealing with countertrade.[77]

The US is another developed country that set up its barter program to dispose of surplus agricultural commodities and acquire strategic materials.[78] As an example, in 1979 Congress passed an act proposing to acquire and retain stocks of certain strategic and critical materials and to encourage the conservation and development of sources of such materials within the United States in order to avoid costly and risky dependence on foreign sources for supplies of such materials in times of national emergency. According to this Act, known as the Strategic and Critical Materials Stock Piling Revision Act of 1979, the President was requested to encourage the use of barter to acquire these materials. Section 6(c)(1) of the Act reads:

> The President shall encourage the use of barter in the acquisition of strategic and critical materials for, and the disposal of materials from, the stockpile when acquisition or disposal by barter is authorised by law and is practical and in the best interest of the United States.[79]

In accordance with the Act, some barter deals have been concluded. For instance, the US Government entered into barter deals with the Jamaican Government to acquire bauxite in exchange for dairy products.[80] The main purpose of the US Government was to reduce its existing deficiency in bauxite, classified as a strategic material, and to export agricultural

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76 Palia, "Countertrade Practices in Japan" (May 1993) 22 *Industrial Marketing Management* 125 at 130.
77 At 126.
78 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 14-15.
79 Public Law 96-41 [H.R. 2154]; July 30, 1979.
80 James & Dunne, "Jamaica to Barter Bauxite for US Dairy Product Imports" (November 21, 1983) *Financial Times* at 4.

commodities, avoiding a depression in their prices in the world market. The barter agreement required Jamaica to provide 400,000 tonnes of metal grade bauxite and the US to deliver an equivalent value of certain dairy products.[81] It should be noted that according to a study carried out by the US International Trade Commission, goods imported to the US under countertrade transactions are mostly ores and metals.[82]

Companies in need of raw materials may enter into buy-back arrangements with developing countries in order to provide assistance to these countries in respect of development of mines and extraction or processing of raw materials. Since a specific quantity of raw materials extracted are to be bought back by the companies providing machinery and equipment, the companies have access to raw materials over a long-term period. The use of countertrade for acquiring raw materials has been so beneficial to many companies that the purchase of raw materials has continued, even after the completion of countertrade commitments. According to a survey of 500 companies in the US, 53% of the companies which responded said that they continued purchasing raw materials even after the countertrade contract was completed.[83]

8. Political Objectives

The foreign trade policy of a country may not always be based on economic considerations. Political grounds may also play a role in outlining the trade policies. These political interests may be concerned with foreign policy or domestic political situations. The foreign

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81 Lee, "Bauxite for Butter: The US Jamaican Agreement and the Future of Barter in US Trade Policy" (1984)16 *Law & Policy in International Business* 239 at 248.

82 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 18.

83 Carter & Gagne, "The Dos and Don'ts of International Countertrade" (1988) 29 *Sloan Management Rev* 31 at 36.

policy of a country may be based on strengthening its allies, weakening the economic strength of rivals or encouraging particular countries to change their behaviours and policies. Domestic political goals include the satisfaction of certain groups, such as unions, the protection of particular industries, the avoidance of becoming dependent on particular foreign resources for strategic materials, and ideological or religious considerations. A government may use its State-owned enterprises or legislative authority to achieve political goals through trade policies. Such trade policies may be adopted merely for political reasons but at a cost to the whole nation.

The use of countertrade as a form of international trade may be motivated by political or military reasons. For many years centrally-planned countries have used various forms of countertrade among themselves to strengthen their political and economic positions.[84] These countries have also used countertrade with developing countries to loosen the ties of newly-independent countries with the former colonial powers to which they belonged.[85] Khrushchev, the then Soviet Union leader, once explained to a group of visiting US senators: "We value trade least for economic reasons and most for political reasons".[86]

Similarly, the use of countertrade for political goals is prevalent in Western countries. Countertrade in the form of offsets has been used by the US in relation with its NATO allies to support their military forces. The military goals of these offset arrangements include the creation of national defence industrial bases, modernisation of military equipment, and

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84 Paul Baran, an economist commenting in 1947 on Soviet trade policy, remarks:

> Dealing with countries competing with each other for the Russian market, the Soviet foreign traders may be in the position to strike favourable bargains with individual countries, conclude barter and clearing agreements, and secure special advantages in the terms of trade, etc.

Kostecki, *East-West Trade and the GATT System* (St Martin's Press, New York, 1979) at 3.

85 Sawyer, *Communist Trade With Developing Countries* (Praeger, New York, 1966) at 58.

86 Staar, *USSR Foreign Policies after Detente* (Hoover Institution Press, Stanford University, 1987) at 132.

promotion of political ties.[87] The US has also used countertrade for foreign political goals in its relations with some developing countries.[88] As an example, one reason underlying the engagement of the US Government in barter deals with Jamaica has been to support an ally in the Caribbean region. In this regard, Ronald Reagan, the then US President, said:

> Agricultural barter to require needed raw materials will thus be used for the first time in almost 15 years. This barter arrangement follows from the congressional mandate contained in section 6 of the Stockpiling Act of 1979.
> While improving our own defense posture, this program will contribute to Prime Minister Seaga's strategy for Jamaica to rely to the maximum extent possible on production and exports to fuel its economic recovery. The stability and economic strength of Jamaica are important to our national security interests in the Caribbean.[89]

Sometimes the motivation for choosing countertrade policies is domestic political considerations. To increase the chance of re-election, governments in democratic countries may focus on trade policies which create short-term benefits at the expense of long-term ones. For example, offset programs in certain developed countries may be motivated by internal affairs. The need to purchase costly military hardware abroad and its inelastic demand encourage these countries to adopt offset programs to satisfy their people that such costly purchases benefit the country by creating more employment opportunities within it.

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87 Welt, "Military Offsets" (March 1984) 396 *National Defense* 20 at 22.

88 A political goal may also be the reason why a country blocks a countertrade transaction. In March 1995, for example, a $1 billion buy-back deal was entered into by Conoco, a subsidiary of the US DuPont Company, and the National Iranian Oil Company. According to the agreement, Conoco was to develop two major oil and gas fields on Sirri Island in the Persian Gulf. In return, Conoco was to buy back crude oil flowing from the fields. The Clinton administration declared that the agreement was inconsistent with US policy. The White House said: "This kind of cooperation with Iran is inconsistent with our policy of bringing pressure on Iran to change its unacceptable behaviour." Eventually, Clinton issued an order barring US companies from such ventures with Tehran. Following the announcement, Conoco said: "The agreement with the National Iranian Oil Company was contingent on the approval of DuPont's board and clearance would not be given if the US Government opposed the agreement. Clinton administration blocked Conoco from going ahead with a countertrade agreement, which would have been advantageous to Conoco in particular and to US economy in general, only for political objectives. For more details see Greenberger, "Clinton Administration Blasts DuPont's Conoco Until Over Oil Contract with Iran" (8 March, 1995) *Wall Street Journal* at A4; and Greenberger & Sullivan, "Clinton Bars Conoco Plan for Iran Project" (15 March, 1995) *Wall Street Journal* at A3 and A6.

89 Public Papers of the Presidents, (November 24, 1981) *1981 Pub. Papers 1089*; available in Lexis-Nexis, US Government Library.

The use of countertrade for political ends may also occur when public opinion of a given country is against foreign investment or borrowing money from international sources. In these circumstances, countertrade may be chosen as an alternative method to direct investment or loan accumulation. By choosing countertrade a government may argue that the involvement of foreign firms in economic projects creates no financial burden on the current external payments of the country or that the projects will create more jobs because certain components of the project are to be produced within the country. In other words, these governments may argue that the cost of such projects will be compensated by counter-exports or other benefits.

9. Overcoming Trade Barriers and Non-favoured Regulations

The movement of products, services and money across borders may face many barriers and restrictions. These trade or financial barriers restrict involvement of particular businesses in international trading activities. At times, the motivation behind countertrade is to overcome the barriers which exist in international trade. Countertrade may be used in this way to overcome exchange rate restrictions, to disguise actual prices, to avoid quota arrangements, to circumvent tariff and tax regulation, to bypass direct investment difficulties, and to elude debt repayment obligations.

9.1. Overcoming Exchange Rate Restrictions

Countertrade may be used to elude exchange rate restrictions which may be in practice in either the importing or exporting country. A country may fix a rate for its currency which is overvalued in relation to other major currencies. An overvalued currency makes imports cheap and exports expensive.[90] To control the inflow of cheap imports into the country, hard currency payment may be restricted to particular imports. In these circumstances, while imports may face restrictions in payment, exports become less attractive because of the distortions caused by the overvalued and fixed exchange rate policy. One way to circumvent such exchange rate regulation is to link imports to exports under countertrade schemes.[91] The following two hypothetical examples illustrate the role countertrade would play in avoiding exchange rate restrictions.

i) Suppose in Iran there is a fixed exchange rate of 3000 Rials to one US dollar, although in reality 5000 Rials equal one US dollar. On one hand, this overvaluing exchange rate benefits the importers, because it enables them to spend only 3000 Rials to acquire one US dollar to import products. Since the foreign products imported to Iran are cheaper, the Iranian government puts restrictions on payments to control the inflow of imports. On the other hand, the exporters of local products such as Persian carpets have to exchange their dollars obtained at a rate of R3000 to $1 instead of R5000 to $1. Since for every single dollar obtained the exporters earn R3000 in place of R5000, the revenue from exports declines. By exchanging particular local products for the equivalent value of foreign products under a countertrade transaction the Iranian exporters could increase their export revenue and the foreign importer could be paid. Since the carpet exporters receive their prices in kind, rather than in cash, they can make more revenue when they sell the imported

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90 De Miramon, "Countertrade: An Illusory Solution" (May 1985) 134 *OECD Observer* 24 at 25.
91 Banks, "The Economics and Politics of Countertrade" (1983) 6 *World Economy* 159 at 165.

products in Iran's markets against Rials. As a result, countertrade can be used to solve the problem of payment as well as the issue of an overvalued exchange rate.

ii) Sometimes a clearing arrangement is chosen to circumvent the exchange rate regulation in force in a country. Suppose an official rate has been fixed for the exchange of Indian Rupees in terms of other currencies. Accordingly, 25 Rupees is fixed for one New Zealand dollar. A clearing arrangement may be entered into by Indian and New Zealand parties to exchange a particular amount of products over a period of time. Regardless of the market value of one currency in terms of the other, the parties may fix a rate for their own purposes to calculate every R40 as equal to NZ$1. Through this type of countertrade, the parties arrange their own exchange rate which is different from the official rate.

These two examples show that countertrade may be used as a vehicle for selective devaluation of an overvalued currency or as a mechanism to avoid unpleasant exchange rate restrictions. For example, when Mexico imposed restrictions on foreign currency movement, Mexican tyre manufacturers worked out with their rubber suppliers to use cocoa beans as payment for rubber.[92] These examples also show that countertrade may protect the trading parties from the risk of exchange rate variation. Since in clearing arrangements the exchange rate is fixed or varied in a predetermined way, the risk of appreciation or depreciation in either currency will be reduced.[93]

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92 Segal, "Malaysia Changes its Tune on Swap-shopping Deals" (January 27, 1983) 119 *Far Eastern Economic Rev* 50 at 52.

93 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 8.

9.2. Disguising Actual Prices

Countertrade may be used to conceal the real price of an international transaction.[94] For a variety of reasons the parties may wish to disguise sale or purchase prices. When a producer sells its products to a number of customers, any discount given to a particular customer may adversely affect its relationship with the others. The producer may be under legal or moral obligations to give similar discounts to the others. By means of countertrade a producer may sell its products at different prices to different buyers avoiding any negative impact on other buyers. For example, when a coffee producer sells coffee to a number of its customers at $1 a pound and wants to sell its surplus coffee at a discount without damaging its relationship with other purchasers, countertrade is a suitable vehicle to achieve this goal. If under a barter deal a particular amount of coffee is exchanged for a specific number of manufactured products, it is difficult to determine the actual price of the deal. As a result, the seller may sell products on preferential terms to one buyer by way of countertrade, keeping its normal trading relations with others.[95]

The second justification for a seller to conceal the price is to avoid violating a multilateral treaty forbidding sales below an agreed price. Producers of a specific commodity may set up a cartel-like organisation in order to stabilise market prices of the commodity, to keep the prices above the market prices, or to avoid price reduction wars. The Organisation of Petroleum Exporting Countries (OPEC) and the International Bauxite Association (IBA)

94 Weigand, "Apricots for Ammonia: Barter, Clearing, Switching, and Compensation in International Business" (Fall 1979) XXII(1) *California Management Rev* 33 at 39.

95 One justification for price discrimination arises when fixed costs of the production are relatively high, because, for example, the law prohibits release of employees. In this situation, selling above variable costs is in the producer's interest, so far as such sales do not impair its normal trading markets. Hennart, "Some Empirical Dimensions of Countertrade" (1990) *J International Business Studies* 243 at 249.

are two international cartels established to control the flow of oil and bauxite in the international marketplace.[96] These cartels have required members not to sell below the approved prices to keep prices above the market prices. A party to these multilateral treaties may use countertrade as a way of increasing sales without appearing to undercut the official prices agreed on.[97] When oil prices rose sharply in the 1970s, countertrade was used by some OPEC members to sell oil at a discount without openly violating the OPEC official prices.[98] Some petroleum refiners agreed to purchase oil if the price were to be paid partly in cash and partly in products.[99] Under these countertrade arrangements, although oil was priced exactly at the required price, the goods to be paid for oil were priced at higher than their normal price. According to a study by the Washington-based Petroleum Finance Company, 15% of the total OPEC quota was exported outside the limitation of the OPEC pricing system through countertrade arrangements.[100] Thus, it can be seen that countertrade may help a member to sell at discount without expressly violating official prices.

The third situation encouraging a seller to disguise the real price is that expressing the real price in the contract may result in the implementation of anti-dumping or countervailing rules which are in force in the destination countries. In accordance with Article VI of the GATT 1994, a case of dumping takes place when a party introduces its products into

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96 Banks, "Constrained Markets, 'Surplus' Commodities and International Barter" (1985) 38 *Kyklos* 249 at 257.

97 When in 1973 the price of aluminium was controlled, some aluminium producers used countertrade in form of barter as a way around the price control. Weigand, "International Nonmonetary Transactions: A Primer for American Bankers" (1979) 96 *Banking L J* 225 at 238.

98 Weigand, "Countertrade in Chemicals" (August 14, 1978) *Chemical & Engineering News* 32 at 40; Welt, "New Directions in Middle East Trade: Offsets and Countertrade" (1986-7) 19 *American-Arab Affairs* 88 at 89; Tschoegl, "Modern Barter" (October 1985) *Lloyds Bank Rev* 32 at 37-38.

99 Weigand, "International Nonmonetary Transactions: A Primer for American Bankers" (1979) 96 *Banking L J* 225 at 237; Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 34; Weigand, "International Trade Without Money" (1977) *Harvard Business Rev* 28 at 42.

100 "Most OPEC Oil Can Bypass Official Price Without Violating Agreement" (July 16, 1987) 65(136) *Platt's Oilgram News* at 3; available in Lexis-Nexis, News Library.

another country's market at less than the normal value, causing or threatening material injury to the latter country's established industries. Dumping products in a country entitles that country to take some action to protect its industries which are injured or at threat of injury. Similarly, importing of subsidised products to a country entitles the country to impose countervailing duties to offset the advantages which flow from the subsidy. Although certain rules have been developed on the valuation of goods for customs purposes to deal with cases where the price is not mentioned or the price is not an actual one,[101] the use of countertrade could at least complicate the process of determining the value of goods imported.

Sometimes domestic considerations induce a party to hide the real price of a product in international business. In a number of countries, the purchase of agricultural or dairy products is guaranteed by governments at a fixed price in order to support agricultural producers. As a result of such supportive policies, domestic consumers may have to pay more for agricultural products. To dispose of surpluses in the international marketplace, a government may need to sell them below the domestic prices. Selling surpluses cheaper abroad may create political difficulties for a government. To avoid such domestic troubles, a government may disguise real prices by linking the export to imports under a countertrade arrangement.[102]

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101 For example, the Agreement on Implementation of Article VII of the GATT 1994 is an international agreement dealing with the issue of the valuation of goods for customs purposes.

102 Hennart, "Some Empirical Dimensions of Countertrade" (1990) *J International Business Studies* 243 at 248-249.

9.3. Avoiding Quota Arrangements

As discussed above, the producers of certain commodities may enter into a multilateral treaty to stabilise their market prices. The agreement may call for every member to export a specific amount in accordance with a quota allocated to each member. A member may not be satisfied with its quota or may need for some reason to export more than its quota. In these circumstances, countertrade may be used by a member to export beyond its quota on the basis that the quota only covers cash sales. The use of quota has been a long standing process in the OPEC to keep oil prices at a specific level. OPEC members which have not been satisfied with their quotas used countertrade from time to time to produce more oil, avoiding violation of the quota arrangement.[103] Since countertrade was used to avoid quota restrictions, the OPEC has forbidden the use of countertrade to sell more than the quota allocated for a member.[104] However, some members may continue using countertrade to produce more oil, although they may claim that the countertrade deals are within their quota and they are in accordance with OPEC policies.[105]

9.4. Avoiding Taxes and Tariffs

Over time the avoidance of tax and tariff has proved a strong incentive for selecting countertrade.[106] Although some countries have adjusted their tax and tariff regulation so as

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103 Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 34.

104 Bruno, "Countertrade in the Middle East" (November 1984) 7(11) *Middle East Executive Reports* 18 at 19.

105 Cragg, "Damaging Influence to the Cohesion of OPEC" (February 7, 1985) *Financial Times* at 4.

106 Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 32.

to control the use of barter and countertrade by parties to escape paying taxes,[107] the possibility of avoiding income or sales taxes is greater when countertrade has been used, because it is easier to disguise the actual value of products countertraded. It should be noted that certain countries may provide tariff or tax concessions for the goods exported or imported under countertrade arrangements. A company may enter into countertrade transactions in order to avail itself of tax or tariff relief provided to such transactions. In China, for example, at times the import taxes levied on finished cars have been less when they have been imported under countertrade schemes.[108]

9.5. Bypassing Direct Investment Restrictions

In some countries where direct investment is restricted or prohibited, countertrade can be used as an alternative to direct investment to get access to foreign capital and technology. Where in the socialist countries foreign investment was totally banned or was under tight restrictions, countertrade in the form of buy-backs was used to inflow foreign capital and skills.[109] A country may desperately need foreign investment to rebuild its economy, to acquire advanced technology or to finance infrastructure projects while the constitution or

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107 In Australia, for example, the Income Tax Ruling No: IT 2668, issued on 13 February 1992, deals with barter and countertrade transactions in terms of assessable income, the monetary value of such arrangements, the allowable deduction, and sales tax implications. Its Paragraph 7 of the Ruling reads:

> The extent to which the consideration received or receivable during a barter or countertrade transaction (either in terms of cash, credit units, goods or services) represents assessable income under subsection 25(1) depends upon the nature of the consideration in the hands of the recipient. The essential principle when dealing with barter or countertrade transactions is that these transactions are assessable and deductible only to the same extent as a similar cash or credit transaction. Similarly, timing principles for the derivation of income and the incurring of expenditure that apply to cash or credit transactions apply equally to barter and countertrade transactions.

108 "China/South Korea Barter Cars" (July 1, 1994) *International Trade Finance*, Section Finance/ Business; available in Lexis-Nexis, News Library.

109 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 12.

regulation restricts foreign direct investment.[110] One way out of these constraints is to encourage foreign investors to engage in buy-back, offsets or build-operate-transfer (BOT). On one hand, countertrade helps the country to access foreign capital and technology without violating its own law. On the other hand, the foreign investors' involvement in countertrade is a viable response to limitations on foreign direct investment in particular markets.[111] An analysis of countertrade transactions reported in *Countertrade Outlook* from June 1983 to the last issue of 1986 shows that the greater the restrictions on foreign investment, the more the need for buy-backs or offsets.[112] As a result, countertrade in the form of buy-backs, offsets and BOT may be encouraged because of restrictions imposed on foreign investment.

9.6. Circumventing Lenders' Requirements

Sometimes countertrade has been used to circumvent obligations imposed by foreign lenders. The lenders may require the borrowing country to allocate a proportion of its hard currency revenue to service the debt. Since the indebted country has to allocate a certain percentage of its export revenue to servicing the debt, the rest may not be sufficient for imports of necessities. One method to bypass such debt repayment obligation is to export products in exchange for the goods needing to be imported. Export under barter, for example, creates no hard currency to be allocated for debt servicing. As a result, by way of countertrade the country may import necessities which are equal in value to the products

110 In Iran, for example, the law puts a number of limitations on foreign direct investment.

111 Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 78.

112 Hennart, "Some Empirical Dimensions of Countertrade" (1990) *J International Business Studies* 243 at 253 & 256.

exported without violating its obligation to allocate a certain portion of export revenue to service the debt.[113]

Conclusion

Why do business people engage in countertrade arrangements based on reciprocity, abandoning conventional trade for cash? There are certain conditions which encourage a country to use countertrade arrangements. These conditions include hard-currency shortage, export difficulties, desperate need of foreign capital and technology, and the existence of barriers to free movement of products, services and money across borders. Many countries believe that in such circumstances countertrade is of more benefit to them than cash-based transactions. Companies demanding countertrade or those responding to such demands also have their own reasons which may vary from case to case. General motivations for countertrade are to enhance exports, to do business in particular markets otherwise inaccessible, to finance imports or projects, to gain access to foreign technology, to secure an inflow of cheap raw materials to the country, to achieve political or military objectives, or to overcome trade barriers and undesirable regulations. Although there is an overlap between these factors, it is not often that a single factor contributes to inducing a trading party to use countertrade. Rather, a mixture of factors may create a situation justifying recourse to countertrade transactions and abandonment of conventional transactions. The benefits of countertrade for a country or for a firm should not, however, cause them to overlook the potential risks and costs.

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113 At 250.

CHAPTER 3

Difficulties and Limitations of Countertrade

Introduction

The benefits and advantages of countertrade, discussed in the previous chapter, should not lead one to ignore its potential difficulties and drawbacks. A thorough understanding of countertrade requires a broad explanation of its pitfalls and costs, which may outweigh the benefits expected from countertrade. The following extracts are some examples of the commonly held views about countertrade which highlight or even exaggerate the difficulties and drawbacks inherent in its practice:

> Barter is generally considered by economists to be an awkward, restrictive and rather undesirable form of international trade.[1]
>
> Countertrade is a grossly inefficient way of doing business. Money was invented to take the difficulty out of trading; countertrade puts it back in. It is a step back towards bureaucracy - which is one reason it suits some people to use it.[2]
>
> We're trying to liberalise trade at a time when markets all over are closing. What happens when you countertrade is that you get an inefficient allocation of resources.

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1 O'Hagan, "International Barter Involving Agricultural Products" (July-August 1962) 11 *Monthly Bulletin of Agricultural Economics & Statistics* 1 at 4.

2 Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 48.

> Every time a company takes back goods that a purchasing country can't sell in international markets, you have introduced coercion into the system.[3]
>
> Many view countertrade as a coercive, anticompetitive practice that serves as an impediment to free and open trade.[4]
>
> The first rule of countertrade is: 'never get involved in countertrade unless it is absolutely necessary; unless no conventional financing method is available or unless real marketing advantages accrue from the deal'.[5]
>
> Countertrade is not a game for amateurs. Even experienced specialists expect, at best, only about one deal in 10 to succeed, and even the successful transactions can prove more expensive and difficult than foreseen.[6]
>
> The next worst thing to losing a countertrade contract is getting one.[7]
>
> The organisation of countertrade requires a high degree of commercial and financial competence and good business skills if products are to be disposed of rapidly and at the highest possible price. But the developing countries themselves are aware that, with few exceptions, they do not have the management capability or information and distribution channels that would be necessary to promote their exports. ... The environment in which countertrade takes place is Darwinian. Having neither a fixed structure (prices or markets) nor trading rules, it makes the strong stronger and the weak - who must bear the additional costs of inefficient procedures - even weaker.[8]
>
> Countertrade arrangements are complex and may be less favourable because of the limited section of lower quality goods and services. Products subject to countertrade may also displace similar products of other suppliers, foreign and domestic, and depending on the degree of impact, other supplier nations may take retaliatory action.[9]

The above extracts show that countertrade may cause problems for the countertrading parties, for the whole international trade system or for the economy of a country. The

3 Beardwood, "Back to Barter: That Cumbersome Old System is Booming While World Trade Languishes. Cause for Worry?" (Summer 1983) *ICC Business World* 6 at 6.

4 McVey, "Countertrade: Commercial Practices, Legal Issues and Policy Dilemmas" (1984) 16 *Law & Policy International Business* 1 at 57.

5 Rees, "Barter for Beginners" (March 1986) *Management Today* 76 at 77.

6 This is a recommendation to would-be countertraders given in Some Guidance for Exporters; quoted from Rees, "Barter for Beginners" (March 1986) *Management Today* 76 at 77.

7 Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 80.

8 De Miramon, "Countertrade: An Illusory Solution" (May 1985) 134 *OECD Observer* 24 at 28.

9 Somay, "Countertrade and Turkey" (March, 1989) 12(3) *Middle East Executive Reports* 8 at 10.

immediate persons who may suffer from practising countertrade are the countertrading parties. Countertrade may benefit no trading partners or it can benefit one of them at the expense of the other. The difficulties caused for the countertrading parties constitute the main concern of using countertrade. In some instances, however, both parties enjoy advantages from a countertrade transaction but third parties not involved in countertrade suffer. In addition, countertrade practices may have negative impacts on the economy of the country using, encouraging or demanding countertrade. The international trade system built up upon multilateral, non-discriminatory and free trade principles may also be damaged by the proliferation of countertrade. As a result, the difficulties and disadvantages of countertrade may concern the countertrading parties, third parties, a nation's economy or the international trade system. The impact of countertrade on the international trade system will be discussed in Chapter 10. The focus of this chapter is on the following sets of difficulties and limitations: i) the disadvantages and difficulties caused for the countertrading parties; ii) the negative effects of countertrade on third parties not participating in the countertrade transaction; and iii) the negative impact of countertrade on the economy of a country. This classification is simply for the purposes of a better understanding of the drawbacks and difficulties of countertrade. In practice, however, countertrade transactions may create all or most of the disadvantages classified here under the different groups.

1. Disadvantages of Countertrade for Contracting Parties

Countertrade may cause a number of problems for countertrading parties. The reciprocal nature of countertrade which requires a double coincidence of wants constitutes the main source of the problems and difficulties for the countertrading parties. The complexity of countertrade transactions also creates certain problems and disadvantages for the countertrading parties. Apart from these problems, countertrade may create some negative consequences for a countertrading party over the long-term if countertrade has led to the creation of new rivals which will threaten its future markets. These three categories of problems will be discussed below under three sub-titles of *double coincidence of wants*, *the complicated nature of countertrade* and *new rivals*.

1.1. Double Coincidence of Wants

The fundamental problem of reciprocal deals lies in the fact that they need a double coincidence of wants. The problem is precisely highlighted by Jevons:

> The first difficulty of barter is to find two persons whose disposable possessions mutually suit each other's wants. There may be many people wanting, and many possessed those things wanted; but to allow an act of barter, there must be a double coincidence, which will rarely happen.[10]

The necessity of having a double coincidence of wants is the major argument forwarded against countertrade. This argument emphasises on the similarity of countertrade with classic barter in requiring a coincidence of wants. A number of scholars have expressed their concerns about this requirement as the main limitation and drawback of countertrade.[11]

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10 Jevons, *Money and the Mechanisms of Exchange* (Kegan Paul, London, 12th ed 1899) at 3-4.

11 Dizard, "The Explosion of International Barter" (February 7, 1983) *Fortune* 88 at 95; Beardwood, "Back to Barter: That Cumbersome Old System is Booming While World Trade Languishes. Cause for Worry?" (Summer 1983) *ICC Business World* 6 at 6; Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 79; De Miramon, "Countertrade: An Illusory Solution" (May 1985) 134 *OECD Observer* 24 at 27; Kumar, *Primary Commodities: Countertrade and Cooperation Among Developing Countries* (Ljubljana, Yugoslavia, 1984) at 56; Liesch, "International Countertrade" in Wilde (ed), *International Transactions: Trade and Investment, Law and Finance* (NSW Law Book Co, North Ryde, 1993) at 194; O'Hagan, "International Barter Involving Agricultural Products" (July-August 1962) 11 *Monthly Bulletin of Agricultural Economics & Statistics* 1 at 2; and Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 48.

To see to what extent the need for a coincidence of wants creates difficulties for the contracting parties, the issue will be examined in respect of three basic forms of countertrade: barter, counterpurchase and buy-backs.

1.1.1. Barter and the Need for a Coincidence of Wants

The main problem in exchanging goods for other goods under a barter deal is the need for a coincidence of wants. When two persons have products to dispose of, they may enter into a barter deal if each one needs what the other has. Under a bartering system, the person wishing to exchange a surplus of wheat, for example, has to find someone who needs wheat and has something the other needs. Similarly, a person wishing to get wheat has to find somebody who possesses wheat to dispose of and wants something that the person has. It is possible that there may be many people who need wheat but do not have what is needed by the owner of the wheat; likewise, there may be many who offer what is needed by the owner of the wheat but they do not need wheat.[12] In addition, even in cases where the coincidence of wants is satisfied, the value of two things may not match. These two requirements are the main obstacles of a system based only on bartering.

Prior to the invention of something to serve as a medium for diverse needs, the scope of trade was very small and quite insignificant.[13] The need for further exchange of goods for other goods encouraged people to use a generally acceptable commodity as a medium of

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12 For an analysis of the role of money in eliminating the need for a double coincidence of wants which is necessary for bartering, see Starr, "The Structure of Exchange in Barter and Monetary Economies" (1972) 86 *Quarterly Journal of Economics* 290 at 290.

13 It might be claimed that that time there was no trade or business in a real sense but most exchanges within tribes took place as gift-giving. Dalton, "Barter" (March 1982) XVI(1) *Journal of Economic Issues* 181 at 182.

exchange. In various areas different commodities became the dominant medium in matching diverse needs. Meat, wheat, fur, salt, gold and silver are some examples of valuable products raised as an instrument to accommodate people in their transactions with each other. The extensive use of favourite stones and precious metals such as gold and silver as a prevailing medium of exchange has led to the development of the money concept. Today trade is based on paper money and bank money which allow for traders with diverse needs to come together.

As a result, a trading system cannot be established solely on barter without the existence of something to serve as the medium for matching diverse needs. Such a deficiency, however, does not challenge the potential role of barter as a supplementary means in a trading system established basically on money. Whenever a double coincidence of wants is satisfied, a barter deal may be advantageous to the parties. Since sometimes each party needs what the other offers, barter survives in internal and international trade as a supplement to the main stream of cash-based deals. Barter arrangements are compatible with every economic system and have been used more or less in the past and the present in all societies from primitive societies to communist or capitalist countries.[14]

In today's international trade the use of barter (pure-barter) is insignificant and infrequent because each party has to need what the other offers. Barter is generally used when the subject matter of the transaction, at least on one side, is primary products or minerals which are needed by most countries and the disposal of which is not difficult. Some of these primary products, such as oil, are dealt with in the international marketplace as money-like

14 Dalton, "Barter" (March 1982) XVI(1) *Journal of Economic Issues* 181 at 185.

products. For example, under a barter transaction between Greece and Algeria, 200,000 tons of Greek wheat were exchanged for 600,000 tons of Algerian crude oil.[15]

In cases where there is no correspondence between the two parties' needs, one potential way to overcome the problem is to engage in multi-party negotiations. Suppose a producer of phosphate is confronted with a surplus and wants to sell the surplus through bartering to avoid damaging its routine prices; suppose further that another company which is making chemical fertilisers needs phosphate but its financial position is not satisfactory. In this example, the former company has phosphate but it does not need a chemical fertiliser, while the latter needs phosphate but it does not have anything of interest to the manufacturing company. The involvement of a third company which needs a chemical fertiliser and can offer something needed by the producer of phosphate will overcome the obstacle through the establishment of a multi-party barter deal.

In sum, barter in its classical form may help if one party needs the specific product offered by the other and in return has something needed by the other. This kind of countertrade is not a new phenomenon in international trade and is generally used when the goods on one side are primary products and minerals. In response to its rigidity, some innovative forms of barter-like arrangements, such as countertrade and buy-back, have been developed to overcome the problem of needing a double coincidence of wants. The following sections deal with the need of a coincidence of wants in respect of counterpurchase and buy-backs to see whether these transactions may help the parties with diverse needs to come together.

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15 Neale & Sercu, "Why Firms Countertrade in Overseas and Domestic Markets" In Kreinin (ed), *International Commercial Policy: Issues for the 1990s* (Taylor & Francis, Washington, 1993) at 104.

1.1.2. Counterpurchase and the Need for a Coincidence of Wants

Counterpurchase is a method of reciprocal deals under which a company exports certain products or services to a country in cash and in return agrees to counter-export some products from the country against cash payment. Two contracts are generally entered into for the exports and counter-exports. The difficulties associated with the need for a coincidence of wants are less problematic in counterpurchase by contrast to classical barter, because a list of products is generally prepared within which the products to be counter-purchased will be chosen. Moreover, the initial exporter has a certain time, from a few months to around two years, to counter-purchase the most suitable products.[16] As a result, the fact that the initial exporter has more chance in selecting appropriate products over a longer time provides a degree of flexibility to counterpurchase arrangements.

1.1.2.1. Problems

Despite such flexibility, the difficulties and limitations arising as a result of the need for a coincidence of wants are not completely overcome because the initial exporter has to counter-purchase certain products which constitutes, in a strict sense, an exchange of goods for goods transaction. If an exporting company has to receive goods instead of cash, the company may need to dispose of products in markets with which it is totally unfamiliar. Products appearing to be attractive to be counter-purchased may turn out to be unmarketable. Products may be poor in quality, fail to meet governmental standards in destination countries or face import quotas. These difficulties could be grouped as follows:

16 See also Chapter 1, pages 15ff.

i) the products available for counter-purchase are not needed by the initial exporter; ii) the list of products within which products are to be counter-purchased is very narrow or some marketable products are excluded; iii) the products offered are poor in quality; iv) the products lack standardisation or are not well matched with consumer expectations in a particular market; and v) the necessity of dealing with different State trading enterprises to counter-purchase.

1.1.2.1.1. The Initial Exporter does not Need Available Products

The primary problem of a counterpurchase transaction arises when the initial exporter does not need the products offered for counter-purchase. Suppose an electronic company based in Western Europe wants to sell computers to Sri Lanka. Suppose further that Sri Lanka, which suffers from a deficit in its external payment, demands an equivalent counter-export from the computer exporter. The computer exporter does not need the agricultural products offered to be counter-purchased, unless it is supposed that the company wants to pay its staff by rice, wheat or Ceylon tea. As a result, undertaking an obligation to counter-purchase often leads to the problem of how to dispose of the goods.[17] For example, a US high technology firm agreed, in return for its export, to counter-purchase twenty tons of Chilean raisins from the next year's harvest. Since at the time of delivery of raisins, the price of raisins was under market pressure, the firm had to dispose of them at a loss.[18] The

17 Dizard, "The Explosion of International Barter" (February 7, 1983) *Fortune* 88 at 95.
18 Sweeney Jr, "The Advantage of Knowledge" (September 21, 1984) *The American Banker* at 43.

problem is aggravated if the demand for counter-purchase commitment is mandated by a government as a compulsory condition for selling goods or services to the country.

1.1.2.1.2. The List of Products is too Narrow

Sometimes the exporting company required to undertake a counter-purchase commitment may be confronted with a list of products which excludes those products needed by the company or those commonly marketable. The more narrow the list, the less chance for the initial exporter to select appropriate products for counter-purchase. In Poland, for example, stockpiles of unsold export goods were allocated for disposal through countertrade.[19] The reason why a country includes some products and excludes some others varies from country to country. Generally speaking, the products excluded from the list are those which that country has no problem in selling in the world marketplace or those needed for internal consumption.

In contrast, the products included in the list may not have an established market, a matter which might have encouraged the party to require their counter-export. The limited range of products available for counter-purchase, associated with the fact that most of the products listed are in surplus and consequently hard to dispose of, puts counterpurchase in line with classical barter. Hence, the difficulty of having a coincidence of wants arises again.[20] Those easily marketable products, such as raw materials, are often not available for counter-purchase, unless they have faced a shortfall in demand.[21] Under a countertrade

19 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 19.

20 Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 80.

21 Banks, "The Economics and Politics of Countertrade" (1983) 6 *World Economy* 159 at 167.

policy in Indonesia, for example, firms exporting products to Indonesia for governmental purposes have to counter-purchase Indonesian products. Some of the most desirable items such as oil have been excluded from the products available for counter-purchase.[22]

1.1.2.1.3. Quality of Products is Poor

The quality of products to be counter-exported could be the greatest concern of those firms undertaking to counter-purchase. Some businesses, economists and scholars have warned traders to be careful about the quality of products offered for counter-purchasing.[23] They have emphasised that the products generally allocated for counter-purchase purposes are those which cannot be sold in the normal course of trading.[24] They argue that if these products could be sold in the international market, there would be no reason for linking them to imports.[25]

The inferior quality of products offered for counter-purchase might be exaggerated in such a way to imply that countertrade is used only to dispose of poor quality goods.[26] Although

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22 Guyot, "Countertrade Contracts in International Business" (1986) 20 *International Lawyer* 921 at 941; Liesch, "International Countertrade" in Wilde (ed), *International Transactions: Trade and Investment, Law and Finance* (NSW Law Book Co, North Ryde, 1993) at 146.

23 Weigand, "International Nonmonetary Transactions: A Primer for American Bankers" (1979) 96 *Banking L J* 225 at 233; Weigand, "Apricots for Ammonia: Barter, Clearing, Switching, and Compensation in International Business" (fall 1979) XXII(1) *California Management Rev* 33 at 34; Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 51; and Crain, "The Death and Growth of Countertrade Subsidiaries in the Consumer-Products Industry" in Korth (ed), *International Countertrade* (Quorum Books, New York, 1987) at 73.

24 Beardwood, "Back to Barter: That Cumbersome Old System is Booming While World Trade Languishes. Cause for Worry?" (Summer 1983) *ICC Business World* 6 at 6.

25 Jim Robb, an international trade specialist with the US Department of Commerce said: "The Soviets don't need any help selling diamonds or oil. They will try to barter goods they can't market successfully themselves." Randall, "The Bloc Party; the Fall of the Berlin Wall is Good News for the Barter Business" (September, 1990) 13(5) *Executive Female* at 40; available in Lexis-Nexis, Business News Library.

26 Welt, for example, said: "Many countries use countertrade to market products of inferior quality or products that are otherwise uncompetitive in the international market. In other words, it is a way

the quality of products to be counter-purchased is a major concern in countertrading, it should not be read as if every product offered is poor in quality or the only reason for countertrading is to dispose of poor quality products. Lacking an established market, for example, by no means indicates that the products are necessarily poor in quality. There are a variety of reasons that a producer may not have access to the international marketplace such as protectionist policies in destination markets and insufficient marketing knowledge or established marketing channels. The quality of products may be only one of the reasons or no reason at all.

1.1.2.1.4. Lack of Standardisation

Apart from the quality, another problem which could be associated with products offered for counter-purchase is that they may not be suitable for the marketing routine of the initial exporter.[27] The products may not fit within the company's normal distribution network because the products may lack standardisation, be totally strange to consumers' expectations or not fit well into the production process of the initial exporter to use them internally.[28] Russia, for example, has its own system of standards which may not fit Western markets.[29] National standards of safety, health, or other specifications may vary from country to country. Products which do not comply with such standards may not be

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of unloading otherwise unmarketable goods." Welt, "The Offsetting Factor" (December, 1985) *Defense & Foreign Affairs* 18 at 26.

27 Folsom, *International Business Transactions* (West Publishing Company, USA, 1986) at 1065.

28 Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 80; Weigand, "Barters and Buy-backs: Let Western Firms Beware" (June 1980) 23 *Business Horizons* 54 at 58.

29 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 46-47.

permitted to enter their markets or they may be prohibited from further supply.[30] The problem of non-standardisation is greater in manufactured and finished products than in raw materials. Consumer products may enjoy a higher level of protection in various countries in terms of safety, health and disclosure of necessary information as to the quantity, quality, ingredients, nature or value of the goods. If such products cause loss or damage, the importer may face civil or criminal liabilities. As a result, the issue of standardisation is quite significant for a company required to counter-export certain products, particularly if it has to counter-purchase finished or consumer goods.

1.1.2.1.5. Dealing with State Trading Enterprises

In some countries, a countertrade policy may require foreign exporters to counter-purchase some local products. The firm that needs foreign products may have nothing to offer to be counter-purchased. In these circumstances, a third firm needs to be found which has something to counter-export. As a result, the foreign exporting company has to sell its products to one firm and buy from the other. When the firm which needs foreign products and that firm having something for counter-exporter are both State trading enterprises, there is a need for coordination between them. Due to cumbersome bureaucracy, particularly in the countries with centrally-planned economies, coordinating between these State firms may be quite problematic for a foreign exporter. Those persons participating in negotiations may not have the authority to finalise the arrangements. Collecting information about export-import rules, tax, foreign investment, joint ventures or other related issues

30 *The Customs (Prohibited Imports) Regulations* (Cth) prohibit the importation of certain goods into Australia.

may be difficult.[31] Because of cultural, social and economic differences, communication between contracting parties may not be adequate. In addition, the exporting firm may have to counter-purchase from more than one State firm, which intensifies the complexity of the arrangement.[32] For example, a US electronics firm which undertook to counter-purchase some products from the former Soviet Union found no marketable products on the list offered by its trading partner. The US firm was permitted to purchase marketable products from three different trading enterprises, but three months later the US firm was informed that the deal was too complicated because of the difficulty in coordinating these State trading enterprises.[33]

1.1.2.2. Solutions

To overcome some of the above disadvantages and shortcomings or at least soften their rigidity, the following ways could be useful for a firm which needs to do business in circumstances where undertaking a counter-export of unwanted products is necessary.

1.1.2.2.1. Reselling Products in a Suitable Market

When undertaking a counter-purchase commitment is a condition for doing business, the exporting company may counter-purchase unneeded local products from the importing party to dispose of them in an appropriate market. If the company needs to counter-

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31 Von Mehren, "The Significance of Cultural and Legal Diversity for International Transactions" (1969) 1 *Ius Privatum Gentium* 247 at 254.

32 Weigand, "Barters and Buy-backs: Let Western Firms Beware" (June 1980) 23 *Business Horizons* 54 at 56; Weigand, "International Nonmonetary Transactions: A Primer for American Bankers" (1979) 96 *Banking L J* 225 at 240.

33 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 15.

purchase certain products to resell them, certain precautions should be taken prior to concluding the contracts to avoid unexpected consequences. These considerations include:

i) The possibility of finding buyers for the products ought to be considered carefully before entering into any obligation. Marketing information should be collected to determine whether there is anyone at all interested in buying the products, and to what extent and for what reasons the products are difficult to dispose of in a particular market. It is also necessary to determine the likely destination for the products as well as whether they are to be marketed in the company's home country, in a region, or in the international marketplace. The determination of reasons why a product is hard to sell may help the company to deal with the problem efficiently. It is to be noted that energy products often have a steady demand and finding buyers for them is not a problem. Other minerals such as bauxite and iron ore are also needed by almost all developed countries. The intermediate goods such as petrochemical products may, though on a lesser scale, be easily sold in the international market. Less favoured goods tend to include consumer goods, manufactured and finished products which may not satisfy the expectations of consumers in a given market and may suffer from inferiority in quality.

ii) In addition to the marketability of the products, it is also necessary to determine whether reselling the products could create unpleasant short-term or long-term consequences for the exporting company. For example, the distribution of the products through its marketing network may damage the company's reputation for supplying high quality goods.

iii) Sometimes the party who demands counter-exports puts some restriction on the resale process. The counter-purchaser may be required to resell the products in a specific region such as South-East Asia or to particular buyers. At times, the counter-purchaser is required not to sell the products to specific countries or companies.[34] For example, in accordance with the Arab boycott against Israel, no oil purchased from these countries was permitted to be sold to Israel.[35] The reasons underlying these restrictions vary from one country to another. In addition to political purposes, the country imposing such restrictions may want to penetrate new markets for its products without damaging its traditional markets in other territories. Alternatively, the country may have already granted an exclusive distribution right to a firm within a specific territory and be seeking to exclude any other firms from reselling within the restricted area to avoid any violation of the exclusive distribution arrangement. Regardless of reasons underlying such restrictions, the company seeking to undertake a counter-purchase obligation should carefully consider the restrictions imposed on the resale process. The fewer the restrictions imposed, the greater the opportunities to dispose of the products. As a result, it is beneficial to the exporting company to obtain the products as free from resale restrictions as possible.

iv) Another factor to be taken into consideration is the amount of money which can be obtained through reselling the products. At times, the counter-purchaser may have to dispose of the products at a discount ranging from 10% to 50% of their market prices as a result of having no marketing experience or network. The counter-purchaser often compensates for such a margin through purchasing the products below their market price or through increasing the price of its own products initially exported. Reselling the products

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34 Nugent, "US Countertrade Policy: Is it Economically Sound?" (1986) 19 *George Washington J International & Economy* 829 at 842; Weigand, "International Trade Without Money" (1977) *Harvard Business Rev* 33 at 34.

35 See generally Turck, "The Arab Boycott of Israel" (1977) 55 *Foreign Affairs* 472.

may create additional costs for the counter-purchaser which should also be calculated in determining net benefits. These additional costs may be incurred as a result of warehousing charges, negotiations, insurance, packaging, transportation or advertising.

v) The unloading of a huge amount of products on a particular market may lead to the imposition of anti-dumping and countervailing duties. The unloading of huge amounts of cheap goods in a particular market in one shot or during a short period could be considered unfair trade. Every country has its own regulations to deal with the cases perceived as unfair trade practices which cause or threaten material injury to domestic industry. [36] An additional tariff may be imposed on the products as a result of anti-dumping laws if the products are perceived as being sold below the price generally charged for such goods.[37] The products may attract countervailing duties if they are perceived as being subsidised.[38] Such additional tariffs make the products more expensive in a given market and the resale of them may make less profit for the counter-purchaser.

1.1.2.2.2. Providing Assistance to Improve Marketability of the Goods

In cases where the products offered to be counter-purchased are not marketable in a particular area because of their quality, non-standardisation, shape, taste or packaging, the counter-purchaser may provide some assistance to the producer to adapt the products to the destination market demands. If the products contain some ingredients which are not acceptable in that particular market or the technical system of products is not homogeneous

36 Rinaldi, "Can US Anti-Dumping Law be Effectively Applied to Countertrade Transactions?" (1987) 19 *Case Western Reserve J International L* 441 at 447.

37 See Article VI of the GATT 1994 ss2-3 and Agreement on Implementation of Article VI of the GATT 1994 which deal with anti-dumping measures.

38 Section 3 of Article VI of the GATT 1994.

with market specifications, the counter-purchaser may render some assistance and information so as to improve the products and adjust them to market needs. Such assistance may lead to improvement of products in terms of quality, taste, appearance, packaging and technical standards. For example, under a countertrade arrangement between the Coca Cola Company and Yugoslavia, Coca Cola sold syrups to Yugoslavia and in return agreed to market a Yugoslavian wine in the US market. Since the taste of the wine was not acceptable to the American consumers and the bottle was not attractive, Coca Cola worked with the Yugoslavian grape producers to improve the taste of the wine and redesign the bottles. As a result of providing such assistance, a hard-to-sell product became a product that was converted to hard currencies in the US market.[39]

1.1.2.2.3. Involvement of a Third Party

When an exporting company has to undertake a counter-purchase commitment as a condition of its own exports, the company may call a third party to undertake or to implement such a counter-purchase obligation. The third party may participate in a multi-party negotiation as an independent party to purchase the products, or the obligation is assigned to the third party to be implemented on behalf of the initial exporter undertaking to counter-purchase.

39 Mishkin, "Countertrade I" (1989) *International Business Lawyer* 402 at 403.

1. Multi-Party Negotiations

An exporting company confronted with a counter-purchase demand may look for a third party which either needs the products offered or is able to dispose of them to get involved in multi-party negotiations. Under this mechanism, the exporting company exports certain products to the importing country and the third party undertakes to counter-purchase some products from the importing country. Generally, the exporting company is paid in cash for the products exported to the importing country, the third party pays cash to the importing country for the counter-purchased products, and the exporting company pays a premium to the third party for its involvement in purchasing local products. Under such a multi-party arrangement, the exporting company is generally under no responsibility in relation to the counter-purchase obligation, but rather the third party is responsible for implementing the counter-purchase commitment. Three separate contracts may be concluded: one contract between the exporting company and the importing country for the initial export; another contract between the third party and the importing country for the counter-purchasing; and a third contract between the exporting company and the third party for the payment of a premium. In some cases, however, the exporting company may have a joint responsibility with the third party in relation to the counter-purchase commitment.[40]

The third party may be a company which needs the counter-purchased products for its internal consumption or to resell in a given market. Trading houses specialising in the disposal of countertraded goods may also engage in multi-party negotiations to undertake

40 See Chapter 8, pages 329-330.

to purchase counter-purchased products.[41] The involvement of the third party in countertrade often results in extra costs for the exporting company. These costs may range from 10% to 50% of the counter-purchase price. The involvement of trading houses often costs more for the exporting company, compared with finding a firm which needs those products.

2. Assigning Obligations to a Third Party (Switch Trading)

In some cases, the countertrade contract is negotiated and concluded by the contracting parties without the involvement of a third party. The exporting company which has the obligation to counter-purchase certain products may assign the obligation to a third party. The third party usually fulfils the counter-purchase obligation on behalf of the exporting company. However, the party requesting the counter-purchase commitment may want to restrict transfer of the obligation or totally ban the assignment. During negotiations, the issue of transferability and non-transferability should be worked out, otherwise it might give rise to dispute. To this end, a clause is generally inserted into the contract permitting the obliged party to transfer its commitment to a third party.[42] Such permission may not necessarily imply that assignment discharges the exporting company from its counter-purchase obligation. The assignee may be perceived to be the agent of the exporting company, unless otherwise provided in the contract.[43] In some cases, trading houses or brokers purchase the products to be counter-purchased or find customers for the goods against a premium.

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41 For a list of these specialised companies see Morrison (ed), *Directory of Organisations Providing Countertrade & Offset Services 1996-97* (CTO Data Services Co, Virginia, USA, 6th ed 1996).

42 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 51.

43 See Chapter 8, page 329.

1.1.2.2.4. Purchasing Goods in Advance

To overcome the difficulty in achieving a double coincidence of wants, an exporting company may agree to purchase favoured products from the trading partner prior to exporting its own goods. When the exporting company realises that doing business with a particular trading partner depends on undertaking a counter-purchase requirement, the company may find it more advantageous to purchase some products in advance to pave the way for its own subsequent exports. Advance purchases are also beneficial for the exporting company because it allows the company to select more suitable products in relatively more time and in a relaxed situation. That is partly because the company is under no obligation to purchase something in advance in contrast to counterpurchase where the exporting company has to counter-purchase. The exporting company should make sure that such advance purchases will be considered as satisfying the counter-purchase requirement. The money obtained from the advance purchase may be allocated to be used by the exporting company for its subsequent export.[44]

1.1.2.2.5. Using International Trading Certificates (ITC)

When a country mandates that imports to the country should be compensated by counter-exports, a trading firm exporting something from the country may want to reserve its right of equivalent imports to the country. Such a right to export to the country may be managed through issuance of an International Trading Certificate (ITC) in association with the

44 For more details see Chapter 8, pages 334-352.

Central Bank of the country. The company which exports some products from the country issues an ITC certifying the amount of local products exported. The ITC must also be endorsed by the Central Bank of the concerned country. The ITC grants an irrevocable right to the holder to import goods of equal value to the country and to receive the price in hard currency from the country. Since the major feature of this instrument is its transferability to third parties,[45] the ITC holders may sell it in a market to those seeking to export to the country. The purchase of an ITC enables the exporting company to export without counter-purchasing. The value of ITCs depends on various factors including the amount and kind of products permitted to be imported to the country, the time period of its validity, the degree of limitations on its transferability, and their supply and demand.[46]

1.1.2.2.6. Using Clearing Arrangements

To overcome the difficulty of having a coincidence of wants, the parties may set up a clearing arrangement under which the parties agree to exchange up to a set amount of goods or services without transferring hard currencies from one country to another. Clearing arrangements are advantageous to the trading parties in two respects. First, clearing arrangements provide an equal opportunity to either party to purchase first. The trading parties may chose whether or not to purchase from one another simultaneously. Second, clearing arrangements grant the parties an opportunity to select the most suitable products over a longer time. Even if one trading partner cannot find suitable products to purchase, the arrangement often provides flexible ways to deal with the problem including

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45 Boliek, "International Trading Certificates" in Korth (ed), *International Countertrade* (Quorum Books, New York, 1987) at 105 & 110.

46 For more details see Chapter 8, pages 353-357.

granting more time to the party who has failed to purchase up to the agreed amount, allowing that party to transfer its obligation to a third party, or requiring that party which has purchased more to pay the difference in cash.[47] These elements give a flexibility to clearing arrangements in the area of selecting appropriate products to purchase.

1.1.2.2.7. Paying a Penalty

In cases where the exporting company is required to counter-purchase, a penalty clause may be included in the contract to the benefit of the importing party if the exporting party fails to fulfil its counter-purchase commitment. The company which has already exported its products may prefer to pay the penalty instead of fulfilling its counter-purchase obligation. As a result, paying the penalty is an alternative to counter-exporting unwanted products.

This method, however, has two major problems. First, the penalty may be so high that the exporting firm cannot afford to pay it. In Indonesia, for example, the penalty is 50% of the value of any unfulfilled counter-export obligation.[48] The payment of the penalty is generally preferable when the penalty is less than the discount the exporter needs to bear to resell the goods.[49] Second, the payment of a penalty instead of performing the counter-purchase requirement often disturbs the trading relation of the parties. The issue of the penalty is usually preceded by the breach of a contractual provision which can seriously affect the future relations of the two parties. If the continuity of business in not a concern for the exporting partner, it may prefer paying the penalty to performing the counter-purchase. It

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47 See Chapter 1, pages 36-37.

48 Guyot, "Countertrade Contracts in International Business" (1986) 20 *International Lawyer* 921 at 935.

49 Dort, "Some Contractual Problems of Countertrade" (1989) 17 *International Business Lawyer* 366 at 366.

should be noted that payment of penalty may not discharge the obliged party of its counter-purchase commitment in some legal systems.[50] As a result, the payment of a penalty as a way to escape from counter-purchasing should be considered the last alternative even if it is effective and economically desirable.

In conclusion, whenever a company decides to export under counterpurchase, it should consider whether there are any products available for counter-purchase needed by the company for internal consumption. If the available products are not needed by the company or they are not fit for the company's marketing network, the exporting company needs to market the products. Since marketing requires expertise and knowledge, it may be in the interest of exporting companies to use the assistance of organisations and consultants specialising in handling countertrade products, especially if their involvement in countertrade is infrequent. Some larger companies with enormous countertrade commitments may prefer to set up their own in-house countertrade department to handle the goods internally. The functions to be performed by the department include marketing the goods counter-purchased, providing assistance to the producers to improve the quality of the goods, or selecting the most appropriate products. Some exporting companies cannot afford to support the salaries and operating costs of the internal department and consequently prefer to use the services of specialised organisations, especially if they only need such assistance occasionally.

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50 See Chapter 8, pages 324-325.

1.1.3. Buy-Back and the Need for a Coincidence of Wants

Since under buy-back arrangements the resultant output of the facilities supplied is to be bought back, the supplier knows the kind of products to be purchased in return. The difficulty of needing a coincidence of wants is still a major concern because the supplier of facilities is required to buy back the output - which may be undesirable. The potential difficulties arising as a result of the supplier's undertaking to buy back the output include:

i) The resultant output is not needed by the exporting firm supplying the goods or services. ii) The sale of the output through the exporter's marketing network may damage its reputation and distribution network, because the goods are poor in quality, unattractive or non-standard. iii) There is generally a gap between the time when the supply contract is concluded and when the output of the project becomes available. During this period the technology may have advanced and consequently the resultant products may not be up-to-date enough. Moreover, when the products become available, the market may be saturated which may cause losses for the exporter. iv) There is considerable uncertainty about the continued availability of products to be purchased back and their quality. Relying on the arrangement, the exporter may enter into certain agreements with other trading parties with respect to the goods to be bought back. Their quality and specifications may also not be as expected because of the use of certain inferior material in their production or unskilled labour.[51] v) The issue of pricing the products to be purchased back is another concern for the parties. Fixing a price for the goods to be produced a considerable time later may create a big concern for the exporting firm undertaking to buy them.

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51 Cho, "Using Countertrade as a Competitive Management Tool" (1987) 27 *Management International Rev* 50 at 54.

Some of above difficulties may not be unavoidable nor are they exclusive to buy-backs. They may be found in any long-term contract. The problem of fixing a price, for example, is a problem for any long-term contract and may be dealt with by setting up a formula according to which the price of the products will be determined later.[52] Concern about the quality of products may be reduced through careful surveillance of the exporter during production. Details of product specifications may be included in the contract so that any fundamental difference would discharge the obliged party from its buy-back obligation.

1.2. The Complicated Nature of Countertrade

The second group of difficulties which may be caused for the contracting parties is related to the complicated nature of countertrade. Countertrade is not a straightforward export contract against cash, but it is a linked arrangement under which exports and counter-exports are connected to each other. In cash-based transactions, efforts generally focus on the products to be exported and their prices; the exporter is concerned about the price and how to get it, and the importer is concerned about the type, quality and the price of the products. Since in countertrade there are two exports in opposing directions, two sets of issues should be worked out in negotiations. In addition, the issue of linkage between these two exports must also be negotiated. Since the process of negotiating and drafting appropriate terms for the exports, counter-exports and the issue of linkage is more complex, the following difficulties may arise for the contracting parties:

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52 McVey, "Countertrade and Barter: Alternative Trade Finance by Third World Nations" (1980) 6 *International Trade L J* 197 at 210; see also Chapter 8, pages 315ff.

1.2.1. Time-Consuming Negotiations

Because of the reciprocal nature of countertrade, a lengthy negotiation may be needed to work out differences over specifications of products to be exported or counter-exported, time of delivery, method of payment and the issue of linkage between the export and the counter-export. The degree of complexity is higher in buy-backs, offsets and BOT, which involve construction, technology transfer, co-production and investment. A number of related contracts may need to be drafted in respect of specification of the project, financing, sub-contractors, pricing, adaptation, licensing, and the kind of obligation to be undertaken by the initial exporter. In addition to these contracts, a framework agreement also needs to be drafted as an umbrella covering these contracts under a tight countertrade mechanism.[53] Although these issues must be discussed in detail prior to making the agreement, reaching an accord on these issues is not always an easy task. The parties have to be patient to reach an agreement on various aspects of a countertrade transaction. During the negotiations, a variety of countertrade proposals may be suggested which prolongs the negotiation process.[54] It is said that for every ten or twenty deals that are negotiated, one may be completed.[55] After a long time of effort, negotiations may collapse without reaching an agreement. Even in cases where negotiations eventually result in a legal arrangement, the time that has been consumed in reaching that end may be long compared with a straightforward sale contract.

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53 Cole, "Evaluating Offset Agreements: Achieving a Balance of Advantages" (1987) 19 *Law & Policy in International* Business 765 at 800.

54 Commonwealth Secretariat, *Countertrade: Guidelines for Developing Countries* (Commonwealth Secretariat, London, 1988) at 41.

55 Dizard, "The Explosion of International Barter" (February 7, 1983) *Fortune* 88 at 94.

1.2.2. Additional Costs

Many persons including lawyers, businesses, bankers and probably a broker need to be involved to conclude a countertrade transaction. It may also be necessary to collect information in respect of engineering, manufacturing, financing, marketing, labour-related issues, legal status and so on prior to making a countertrade deal. Collecting such information or the involvement of various experts creates extra costs for the contracting parties. Moreover, since those persons having experience in negotiating and drafting normal contracts may not be familiar with countertrade mechanisms, a company may need to employ new staff or use the services of a firm having experience and skill in countertrade. Either establishing and maintaining a special unit to provide countertrade support or using the expertise of specialised firms creates extra costs for the contracting parties. These costs may be shifted eventually to the party with less negotiating strength.

1.2.3. High Risk

Countertrade transactions, often associated with a high degree of risk and uncertainty, require commercial skills and business competence. There are many related issues in countertrade transactions where any mistake or ignorance in dealing efficiently with them may result in unpleasant consequences. Uncertainty in availability, quality or the price of goods to be countertraded makes countertrade transactions a risky business. Countertrade transactions to be completed over a long time period are subject to a higher degree of risk, because subsequent changes in countertrade circumstances could affect the final benefit.[56] These changes include the insolvency of the trading partner, export-import regulations, marketing demands for the countertrade products, technology improvement and political instability. In addition, the provisions of the countertrade contract may not be set out in such a way as to avoid unfair imbalances in profits of countertrading parties as time goes on.

Developments in the steel industry and their effect on Japanese firms provide an example of how a long-term countertrade deal may bring unpleasant consequences for one countertrading party. During the 1970s, a number of buy-back arrangements were entered into between Japanese steel companies and several countries such as Australia, Ghana and Brazil under develop-for-import schemes. The resultant output (pelletised iron ore) was scheduled to be given to Japanese partners as the supplier of loans, credit and equipment over 15-20 years. Over time, the technology in steel mills improved in such a way that the use of iron ore pellets became costly. As a result, Japanese companies were faced with a huge amount of unwanted pelletised iron ore undertaken to be bought back.[57]

1.2.4. Financing the Deal

The other problem to be worked out during the negotiation process is the financing of the transaction. With the exception of classic barter, in countertrade there are generally two

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56 The countertrade agreement between the Occidental Petroleum and the former Soviet took 20 years to be completed. Simpson, "Should Australian Companies and Institutions Become More Involved in International Countertrade?" (March, 1996) 7 *J Banking and Finance L & Practice* 17 at 20.

57 Walsh, *Mandated Countertrade: Methods and Issues* (National Center for Export-Import Studies, Staff Paper #16, 1985) at 22.

different contracts for the goods and services initially exported to a country and the products required to be counter-exported in return. There is usually a time gap between the performance of the initial export and the subsequent counter-export. The importing party may have no hard currency reserve to finance the deal nor creditworthiness to obtain credit from financial institutions. In this situation, the initial exporter may have to become involved in supporting the importer in obtaining a credit. Such an involvement is not only risky but also complicated, requiring a lot of preparation to avoid any adverse consequences. It should be noted that borrowing money to support the first export increases the incremental costs of countertrade which are generally transferred to the weaker party, which is often a less developed country demanding countertrade.[58]

1.2.5. Legal Uncertainty

A number of countertrade difficulties result from the fact that legal aspects of countertrade may not be clear and predictable in many legal systems. In many countries there is no particular regulation for countertrade transactions. The disputes arising from countertrade may be managed by virtue of those rules applying to classic barter or through the application of general rules of sales. Moreover, the countertrade transactions are generally drafted on an ad hoc basis and each one has its own characteristics different from others. Due to a lack of standardisation and their innovative peculiarity, the lawyers may not be ready to respond effectively to the needs of their clients. The parties may need to anticipate

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58 Commonwealth Secretariat, *Countertrade: Guidelines for Developing Countries* (Commonwealth Secretariat, London, 1988) at 41.

many contingencies by inserting appropriate provision into the contracts to avoid unexpected consequences.[59]

1.2.6. Conclusion

Countertrade practices have a complicated nature which creates certain problems for the countertrading parties. During negotiations many things are to be managed including the form of countertrade, the type, quantity and quality of goods and services to be exported or counter-exported, setting up a mechanism for determining the prices, and the method of payment of the first and the second purchases. Such complexity may bring about a situation wherein the stronger party could gain advantages at the cost of the weaker. This strong trading partner may be a large, powerful State firm in a centrally-planned country or a multi-national company with dominant bargaining skill and experience.[60] The weaker party can be a small firm in a developed country having little experience and skill in dealing with countertrade requirements or a firm in a developing country demanding countertrade. Moreover, the huge bureaucracy in the countries demanding countertrade may slow down the process of negotiation and contract implementation. Finalising an agreed deal may take time because those participating in negotiations may have no authority to finalise the deal. Having access to information about the export-import rules, tax regulations, direct investment, joint ventures legalisation and other related rules may take time and create additional costs. A company may come to realise many of these obstacles only after spending a lot of money and wasting a lot of time. As a result, those firms seeking to

59 The following Chapters focus on the legal aspects of countertrade.

60 Neale & Shipley, "Effects of Countertrade - Divergent Perceptions Between Practitioners and Non-Participants" (1988) 25 *J Management Studies* 57 at 60.

engage in reciprocal deals should carefully weigh the benefits and costs of any particular deal to see whether they can overcome such problems.

1.3. Creating New Rivals in International Business

Another disadvantage of countertrade for one of the countertrading parties is the creation of new rivals in the market.[61] Over a long-term period, countertrade practices may present a threat to the company supplying technology or undertaking to market the other party's products. It is therefore important for a company required to undertake a countertrade obligation to examine to what extent a countertrade transaction would threaten its future market. Countertrade in forms of counterpurchase, buy-back and offsets may result in creating a new source of competition and may threaten the future market of a countertrading party.

The creation of a new source of competition may occur if the company undertaking to counter-purchase has an established market in relation to the same products. Through its market facilities and network the counter-purchased products suffering from anonymity may find their way to a market. After the completion of the counterpurchase deal, the producer may use a different network for its goods or set up an independent distribution network if the products have been introduced adequately into a market and acquired sufficient

61 Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 57; Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 18-19; Aggarwal, "International Business Through Barter and Countertrade" (1989) 22(3) *Long Range Planning* 75 at 80; and Cho, "Using Countertrade as a Competitive Management Tool" (1987) 27 *Management International Rev* 50 at 54.

reputation. In this way, undertaking a counter-purchase commitment may create a new source of competition for the counter-purchaser distributing the same products.

Buy-back and offset programs are more likely to present a threat to the company supplying the technology, services or equipment to set up a project in a country. In addition to providing such facilities, the company also has to buy back a portion of goods produced by the plant. As a result, there are two possibilities that buy-backs or offsets programs lead to the creation of new rivals: one arising from enabling another party to produce certain products and the other resulting from the obligation to buy back the resultant output.

When a company supplies a country with expertise and equipment to produce certain products identical to those produced by itself, in the short-term the needs of the country for such products are met by the plant.[62] Moreover, unless a restriction is imposed in the contract, the country may export the products abroad which may damage the established market of the company in the long-term. Furthermore, the products manufactured under its technology, licences and know-how may come back into the home country of the supplier of technology and equipment. As a result, the goods manufactured under offset or buy-back programs may compete with the supplier's own products. Under an offset program, for example, Raytheon sold its Sparrow air-to-air missile to Italy and agreed in return to provide facilities and know-how to Selenia Industrie Electtroniche Associate, a major Italian electronics company, and to train technicians. The missiles produced under the program were labelled as Italian-made and sold in international markets. These missiles, known as

62 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 60.

Aspide, somewhat decreased the sales of the Sparrow, because the cost of development of the Aspide was less than that of the Sparrow.[63]

The obligation to buy back a certain portion of the resultant output is another factor in threatening the normal production routine of the supplying company. Suppose, under a buy-back program, the Japanese car company, Toyota, agrees to supply facilities and technology to Malaysia to set up a car manufacturing project producing luxury cars and in return, Toyota undertakes to buy back 50% of cars produced there. To dispose of the cars, Toyota has to decrease its output from other lines or cut the price if the demand for such cars is stagnant. As a result, without creating new markets for the cars to be produced under a countertrade program, the supplier may face difficulties in disposing of them or its own equivalent products.

The goods manufactured under countertrade programs present a higher level of threat to the supplier's established market if they are produced in countries lacking domestic competition.[64] In these countries the goods may be priced in the absence of marketing criteria or may be heavily subsidised.[65] As a result of countertrade programs, goods of comparable quality to those of a well-known brand but at a lower price are a real threat to the established market of the supplier. It should be noted, however, that creating new sources of competition is not exclusive to countertrade schemes. It is perhaps a concern in any transaction under which technology, know-how or equipment for producing a particular

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63 Schaffer, *Winning the Countertrade War* (Wiley, New York, 1989) at 194.

64 Liesch, "International Countertrade" in Wilde (ed), *International Transactions: Trade and Investment, Law and Finance* (NSW Law Book Co, North Ryde, 1993) at 203.

65 For example, in the former Soviet Union prices were not fixed in accordance with supply and demand, but rather by administrative orders. Forker, "Accepting Soviet Goods in Countertrade: Problems with Product Quality" (March 22, 1990) 26(2) *Journal of Purchasing and Materials Management* 13 at 15.

product is given to another party. Fiat, for example, agreed to help Russia set up a car factory for domestic consumption. When the factory was built, its products, known as *Lada* appeared in many foreign markets, competing with Fiat itself.[66]

2. Negative Impact of Countertrade on Third Parties

It is a concern that the countertrading parties benefit from a countertrade opportunity at the cost of third parties refusing to undertake similar counter-export obligations. When a party requests its trading partners to include a counter-export commitment in their offers, those not including such an obligation may lose the deal to those responding positively. So far as the decision is made on a free and fair basis, it is a matter of competition that the company rejecting countertrade has lost the deal to that including countertrade.

However, third parties rejecting countertrade may be affected adversely when a government intervenes in market forces, directly or indirectly encouraging or mandating countertrade practices. As a result of a countertrade policy, the firms not participating in countertrade arrangements may be excluded from a market. A third party suffering from others' countertrade could be: i) an exporting firm having an established market within a given country, but now excluded from the market due to its unreadiness to undertake a counter-export obligation; ii) an exporting firm which has no established market in the country but which loses a trade deal simply because of its countertrade rejection; iii) a foreign producing firm which loses its traditional market because its customers are required to counter-

66 Weigand, "Barters and Buy-backs: Let Western Firms Beware" (June 1980) 23 *Business Horizons* 54 at 58.

purchase the same goods from the party mandating countertrade; and iv) the companies suffering from discriminatory preferential treatment granted only to those undertaking countertrade obligations.

When the products that are required to be counter-exported are primary commodities, countertrade demands cannot make new markets for the products because the demand for primary products is relatively inelastic in international markets.[67] Countertrade requirements may create a new market for the demanding country but at the cost of other producers. This means that mandated countertrade displaces other producers from their competitive positions. This situation encourages other producing countries to mandate countertrade to maintain their marketing shares. For instance, when Indonesia announced that all importers for governmental procurements must undertake a counter-export obligation, one product which was required to be counter-exported was rubber which had a saturated world market. Due to this countertrade policy, Malaysia, another rubber producer, lost some of its market share. To maintain its share, Malaysia also implemented a countertrade policy, requesting counter-exports of rubber.[68]

With a countertrade policy a government may choose to allocate hard currency only for the products imported under countertrade programs; import licenses may be issued for those undertaking countertrade; low priority imports may be dealt with as high priority imports if imported under countertrade; import quotas and embargoes may be eased for imports under countertrade mechanisms.[69] In such a situation, the competition is not in terms of providing

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67 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 23.

68 Walsh, "The Effect on Third Countries of Mandated Countertrade" (1985) 19 *J World Trade L* 592 at 596.

69 At 599.

the best price or quality, but rather to include appropriate countertrade obligations to benefit from preferential treatment. A company which provides better products in terms of quality and price may be disadvantaged through refusal to undertake counter-export commitments.

It is, moreover, arguable that mandating countertrade is an anti-competitive practice in international business. Companies entering the international market may expose themselves to a greater variety of competition than exists in the domestic market. Apart from price and quality, the obligations undertaken by an exporter to the benefit of the other party is part of the package offered by a company. When a contract as a whole is advantageous, it is preferred although the price may be not the best. If an offer to sell 10,000 cars to a country includes an undertaking to produce some of the components within the territory of the purchasing country, the offer as a whole may be more beneficial to the parties even if the offer is at a disadvantageous price. As a result, if a government mandates that foreign exporters must include in their offers certain obligations to the benefit of the importing country, those rejecting such a demand will lose the market to those undertaking that obligation as a matter of competition. Although the offer may be not so advantageous in terms of quality and price, it is more beneficial as a whole because of the counter-obligations undertaken by the exporter. Nevertheless, mandating countertrade may be inconsistent with bilateral or multilateral treaties to which the country is a party.[70] On the other hand, if the countertrade policy provides an equal chance to any foreign companies which include a countertrade undertaking in their offers, the policy cannot be viewed as a discriminatory and anti-competitive practice.

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70 More discussion in Chapter 10.

3. Disadvantages of Countertrade for a Country

Individual traders may benefit from countertrade but at the cost of the whole economic system of a country. The country suffering from countertrade practices may be the country of one of the countertrading parties or both. Countertrade transactions may make the country dependent on certain foreign suppliers, postponing the necessity of economic reforms, lead to reliance on foreign marketing services, reduce employment opportunities and help the parties to by-pass the rules of a country.

3.1. Dependence on Foreign Suppliers

One concern about countertrade arises from the fact that these arrangements may make the country dependent on foreign producers. This might be politically and strategically undesirable. Countertrade practices may put the country in a dependent situation in respect of certain military, energy or primary products. Under offset arrangements, for example, a producer of military systems may be required by its foreign trading partners to produce certain components within their territories or buy them from their local markets prior to installing them in the final products. Such an arrangement may induce the company to produce certain components in those foreign countries. As a result, the company producing military equipment may depend on its foreign subcontractors for material or components necessary for production.[71] The risk of dependence generally arises when some necessary

71 McVey, "Countertrade: Commercial Practices, Legal Issues and Policy Dilemmas" (1984) 16 *Law & Policy International Business* 1 at 60.

components of military equipment are to be produced within the territory of a foreign country with a high level of ideological or political difference.

Moreover, enabling one country to produce the whole or a part of high-technology military equipment may be inconsistent with the national security of the country, creating a threat to the country. Although the issue may not be important for individual companies, such practices may harm the overall defence interests of the country.

Buy-back arrangements may also lead a country to increased dependence on foreign suppliers for essential materials. In cases where companies from industrialised countries undertake to build a major project in a foreign country and agree to buy back the output of the project, a huge amount of products may flow into their countries over a long-term period. These products can suppress domestic production because they are often sold at a discount. Under a countertrade deal between the Occidental Petroleum Corporation and the former Soviet Union, Occidental agreed to render assistance to build an ammonia plant in the Soviet Union. In return, Occidental undertook to purchase quantities of Soviet anhydrous ammonia, urea and potash.[72] An investigation was carried out by the US International Trade Commission to determine whether imports of ammonia from the Soviet were causing market disruption. The report pointed out:

> Certainly the ability of the United States to maintain its highly efficient agricultural productive enterprise is vital to our economy and to our national welfare as well as the free world which is also the beneficiary of our agricultural efficiency. An adequate supply of ammonia for the production of nitrogenous fertilisers is essential. A dependence on Soviet produced and supplied ammonia for a significant portion of our nitrogen requirements would place our agricultural and other national requirements in a vulnerable position. Ammonia plants are capital intensive. Capital requirements will be difficult to obtain to meet current and future needs if the market structure is disrupted by Soviet produced ammonia which is marketed under terms

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72 At 41.

> and arrangements with which the US industry cannot compete because of the disciplines of a free market economy.[73]

As a result, a significant consequence of the inflow of cheap products under a countertrade arrangement could be the potential overdependency on a foreign country for vital raw materials.

3.2. Ignoring the Need for Essential Reforms

Sometimes countertrade has been used in response to economic difficulties a country is experiencing, such as a foreign exchange shortage, external debt problems, a low per capita income, a reliance on exports of raw materials and a lack of skilled labour and technology. Instead of carrying out socio-economic reforms to correct, for example, the exchange rate structure, unrealistic domestic pricing methods, mismanagement or the need for skilled labour, a country may demand or encourage countertrade practices. Although the country may achieve a certain degree of success by the use of countertrade at least in the short-term,[74] it may be not able to correct the fundamental economic difficulties of a country. The success of countertrade in providing temporary relief to an unhealthy economy may allow a country to ignore or to delay necessary fundamental economic reforms.[75]

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73 *Anhydrous Ammonia from the USSR* (US International Trade Commission, 1979, Pub No 1006) at 7.

74 Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 49.

75 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 16.

For instance, when countertrade is used to penetrate new markets for primary products, its success in the long-term is doubtful.[76] The demand for primary products is relatively inelastic in the international market. Due to this inelasticity, a rise in production puts pressure on market price, irrespective of whether the extra products are disposed of through countertrade or not. Moreover, it is likely that other producers also use countertrade either to maintain their market share or to produce more primary products. The commodity producers may become involved in an endless rivalry in overproducing commodities and reducing the prices at a cost to their nations. Since countertrade has a limited capacity to create new markets for primary products, the country in question should adjust its economy to reduce its dependence on exports of primary commodities. As a result, countertrade is not an alternative to reforms necessary for the efficiency of an economy and its use should not delay carrying out such economic reforms.

3.3. Dependence on Foreign Marketing Networks

A further consequence of countertrade practices could be potential dependency on particular foreign marketing networks. A country may use countertrade to sell its products abroad through the marketing services of its trading partners. Such services include marketing channels and packaging, labelling, advertising and after-sale services. Relying on the marketing facilities of trading partners may create two disadvantages for the country in the long-term. First, countertrade may result in a situation where there are only few buyers

76 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 24; De Miramon, "Countertrade: An Illusory Solution" (May 1985) 134 *OECD Observer* 24 at 26.

for its products.[77] These buyers could be those trading partners which agree to undertake a counter-export obligations while having capacity to provide the necessary marketing support through their established marketing networks. The inflexibility and economic inefficiency of a situation where there are only few purchasers for its products do not help the country to improve its economic conditions or its export capacity.

Second, the reliance on the marketing services of trading partners over a long time could prevent a country from developing its own marketing skills and capability.[78] It is significant for a country keen to develop its export capacity to prepare and adjust to the needs and opportunities of international markets. The exporting firms of the country need to improve their marketing knowledge in terms of exploring various marketing channels, adapting their products to the needs of international marketing, and carrying out marketing research. Since countertrade demands shift the responsibility of marketing to trading partners, the country may not attempt enough to improve its marketing knowledge and experience. Although countertrade can facilitate access to international markets, it could prevent a country from developing its marketing capability. As a result, the countries mandating countertrade for marketing purposes should be aware of this negative consequence over a long term period.[79]

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77 Hammond, *Countertrade, Offsets and Barter in International Economy* (Pinter, London, 1990) at 49.

78 Liesch, "International Countertrade" in Wilde (ed), *International Transactions: Trade and Investment, Law and Finance* (NSW Law Book Co, North Ryde, 1993) at 204.

79 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 24.

3.4. Impact on Employment

Countertrade practices may have an adverse impact on employment opportunities of a country in a particular industry. When under a countertrade program a company undertakes to produce certain components of a project sold within the importing country's territory, the employment opportunities would transfer from the exporting country to the importing one. Similarly, when under buy-back or counterpurchase arrangements huge amounts of products flow into a country, domestic producers may lose their share of the market because of their lower prices. Losing the market to foreign producers would increase unemployment rates. For this reason, a leading US trade union, the International Association of Machinists & Aerospace Workers, called "for business, labor, and government to work together to pass legislation and establish regulations that will limit the ability of foreign customers (both public and private sector) to demand offsets".[80] The impact of countertrade on jobs is generally a concern for those industrialised countries required by their importing partners to produce some component of their expensive military exports within the importing country's territories.

3.5. By-Passing Regulations

Countertrade has the potential to be used for by-passing and abandoning the economic regulations effective in a country. Economic rules are generally enacted to implement particular economic policies for social, financial or political purposes. These purposes will

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80 XIII(17) *Countertrade Outlook* (September 11, 1995) at 8.

not be achieved if citizens circumvent the rules enacted to control import-export volume, or regulate the exchange rate and money transfer or collect tax and revenues. In practice, countertrade transactions may be used by trading parties to circumvent these rules. Attempts to get around the economic rules are inconsistent with the objectives underlying legislation and affect the whole system.[81] The situation becomes more confusing if a government itself employs countertrade transactions to circumvent its own rules on export-import, direct investment, exchange rates, tariffs or taxes.[82]

4. Discussion and Conclusion

Since under countertrade practices the exporter is generally required to undertake an extra obligation in favour of the importer, these practices contain inherent difficulties and limitations. An exporting company which is required, for example, to undertake a counter-export obligation may have no experience in disposing the goods to be counter-exported. To have a better understanding of these kinds of limitations and drawbacks of countertrade, the following points should be borne in mind.

i) In discussing the disadvantages of countertrade, it should be made clear who is the supposed victim of countertrade. A countertrade transaction may be beneficial to both trading partners or benefit one at the cost of the other party or third parties. Individual countertrade transactions may have their own advantages for the parties but from a macro-

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81 Goldstein, *Countertrade: a Stop-Gap Solution to Foreign Exchange Shortage* (Federal Reserve Bank of New York, New York, 1984) at 17.

82 Lochner, "Guide to Countertrade and International Barter" (1985) 19 *International Lawyer* 731 at 749.

economic perspective their proliferation may create some difficulties for the international trade system or for a particular country.

ii) The potential difficulties of countertrade transactions entered into on a free basis and upon market forces are fewer compared to difficulties arising from countertrade arrangements made in response to a governmental requirement. The disadvantages of mandating countertrade are greater because a government is intervening in market forces in order to encourage foreign exporters to undertake countertrade obligations.

iii) In the late 1970s and the early 1980s, when international businesses were confronted with a mushroom growth of various reciprocal deals, some either denied their significance or disputed their rapid growth.[83] They feared that international business would go back to bartering and bilateralism. However, since the late 1980s and the early 1990s when various mechanisms of countertrade arrangements have become more widespread and consequently more traders have become familiar with them, positive attitudes about countertrade have been developed.[84]

iv) Initially, the international business community was not ready to provide an appropriate response to innovative countertrade transactions and their demands. Financial institutions had no idea how to support these deals; legal advisers were not sufficiently familiar with

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83 Neale & Sercu wrote: "Initially reported as a highly undesirable, even quasi-illegal practice, it is now regarded as a fact of business life that could expand even more as trading restrictions with eastern Europe continue to loosen." Neale & Sercu, "Why Firms Countertrade in Overseas and Domestic Markets" In Kreinin (ed), *International Commercial Policy: Issues for the 1990s* (Taylor & Francis, Washington, 1993) at 103.

84 Lochner wrote: "Indeed, some of the strongest complaints about countertrade come from smaller, medium-size and specialised firms that are not equipped to dispose of countertrade goods." Lochner, "Guide to Countertrade and International Barter" (1985) *19 International Lawyer* 731 at 748.

linked arrangements to draft appropriate contracts to avoid unpleasant consequences; there were no widespread specialised firms focusing on countertrade and managers were afraid of getting involved in countertrade programs. As a result, some traders made no profits from their countertrade deals. The experience of both winners and losers has led to more knowledge and experience in dealing with countertrade arrangements. Financial institutions and insurance companies have gradually shown more interest in supporting countertrade programs and number of specialised firms and departments have been established for countertrade purposes. As a result of more firms and institutions getting involved in countertrade, its problems and drawbacks have become better known and more manageable.

v) The disadvantages and the limitations attributed to countertrade as a whole may have resulted from practising one specific form of countertrade in particular circumstances. Sometimes, these problems have been generalised to countertrade as a whole. Although countertrade may have some limitations as a whole, in many cases disadvantages are exclusive to particular forms of countertrade in particular situations.

In conclusion, although countertrade may not be free from disadvantages, it is a reality in particular markets and must be coped with if a company wants to become a long-term participant. To overcome its obstacles, large-scale manufacturing companies in defence, aircraft and pharmaceutical industries have set up their own countertrade units to deal with countertrade demands.[85] If an exporting firm views countertrade as inflexible and

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85 Randall, "The Bloc Party; the Fall of the Berlin Wall is Good News for the Barter Business" (September, 1990) 13(5) *Executive Female* at 42; available in Lexis-Nexis, Business News Library.

economically inefficient, it may lose markets to those competitors having a more positive attitude. Potential disadvantages of countertrade can be avoided if the firm has a better understanding of countertrade mechanisms. One method of gaining such knowledge is to set up an in-house countertrade department or to use the services of specialised countertrade organisations. A major area of difficulties relates to contractual obligations, legal aspects and drafting countertrade contracts. These issues will be discussed in the following chapters.

CHAPTER 4

The Conflict of Laws and Countertrade

Introduction

A major concern in drafting countertrade contracts is the lack of uniformity in the substantive legal rules of national laws. Each country has its own rules of validity, interpretation, rights and obligations, discharges, and remedies. A contract may be regarded, for example, as frustrated under a particular legal system but as effective under another; or an innocent party may be entitled under one legal system to withhold or terminate performance as a result of the other's breach but not under another law. On the other hand, countertrade contracts must be legally effective by reference to a law because they could not be construed in a vacuum.[1] The terms of a contract are usually interpreted in

1 The issue that the contract needs to be created under a legal system is well stated in *Amin Rasheed Shipping v Kuwait Insurance* [1984] AC 50 at 65 in the words of Lord Diplock, who said:

> My Lords, contracts are incapable of existing in a legal vacuum. They are mere pieces of paper devoid of all legal effect unless they were made by reference to some system of private law which defines the obligations assumed by the parties to the contract by their use of particular forms of words and prescribes the remedies enforceable in a court of justice for failure to perform any of those obligations; and this must be so however widespread geographically the use of a contract employing a particular form of words to express the obligations assumed by the parties may be.

the light of the law governing the contract. As a result, it is very important for the parties drafting a countertrade contract to determine the applicable law of the contract to ensure that the terms used reflect the parties' intentions. Without such a determination, the parties cannot fully identify the legal effects and contractual consequences of the provisions agreed on in countertrade contracts.[2]

Moreover, the applicable law has a gap-filling function in terms of issues not agreed on by the parties in the contract. It is generally difficult and undesirable to predict all necessary provisions in sufficient detail to cover every aspect of a contract. Even contracts with numerous details might fail to predict every contingency occurring over the life of a contract. This is particularly so with respect to contracts with a lengthy intended lifespan. The applicable law completes contractual provisions of a contract in terms of those issues left unmentioned. As a result, with respect to unmentioned issues, the rules of the applicable law become part of the contract even without the express will of the parties. Furthermore, by virtue of the applicable law, the parties could determine the necessary steps

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However, in *Deutsche Schachtbau-und Tiefbohrgesellschaft v Al-Khaimah National Oil Co* [1990] 1 AC 295 at 316, it has been recognised that the governing law of the contract could be 'internationally accepted principles of law' and it is not necessary that it must be a particular country's legal system. With respect to this case, Professor Schmitthoff noted that the "English Court of Appeal is not isolated in its recognition of a transactional proper law of contract, if the parties so choose or the arbitrators, to whom the ascertainment of the proper law is left, so decide. The supreme courts of France and Austria as well as of Italy have ruled to the same effect." Editorial, "Transnational Law as the Proper Law of Contract" (1987) *J Business Law* 165 at 169. It should be noted that when one party to the contract is an international organisation, the idea of choosing international principles as the proper law has made much progress. In *Serbian and Brazilian Loan* (PCIJ Series A, No 20 at 41), it was said that any "contract which is not a contract between states in their capacity as subjects of international law is based on the municipal law of some country. The question as to what this law is forms the subject of that branch of law which is at the present day usually described as private international law or the theory of conflict of laws." Quoted from *Texaco v Libyan Arab Republic* (1979) 53 ILR (International Law Report) 389 at 443.

2 In *Amin Rasheed Shipping v Kuwait Insurance Co* [1984] AC 50 at 60, Lord Diplock remarks that "the purpose of entering into a contract being to create legal rights and obligations between the parties to it, interpretation of the contract involves determining what are the legal rights and obligations to which the words used in it give rise. This is not possible except by reference to the system of law by which the legal consequences that follow from the use of those words is to be ascertained."

to take prior to availing themselves of certain rights in respect of fulfilling contractual obligations or remedies.[3] Thus, since the applicable law has a key effect on the contractual obligations of the parties, countertrade contracts should be drafted in the light of the governing law.

One of the generally accepted rules in private international law is that the law governing the contract will be determined by virtue of the conflict-of-law rules of the forum and not by means of the law chosen.[4] Since a court determines the law of the contract by applying its own choice-of-law rules which may vary from country to country,[5] the discussion here is continued by reference to the Australian legal system compared to the Rome Convention on the Law Applicable to Contractual Obligations (1980) and the Hague Convention on the Law Applicable to Contracts for the International Sale of Goods (1985).[6]

The Rome Convention, signed by the EEC Member States on 19 June 1980, aims to strengthen confidence in the stability of legal relations between the States and anticipate more easily the law which would be applied when a transaction is related to more than one single State. Some Member States have incorporated it into their national systems of

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3 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 162.

4 In *Oceanic Sun Line Special Shipping v Fay* (1988) 165 CLR 197 at 261-262, Gaudron J concluded that "the proposition that the lex fori determines (inter alia) questions as to the existence, construction and validity of terms bearing upon determination of the parties' agreement as to the proper law. Indeed I think that must be so. If the question of what is the proper law is one to be answered by application of the lex fori, until the lex fori provides the answer to that question there is no scope for the operation of any other law. In other words, all questions which are necessarily antecedent to a determination of the proper law of a contract must fall for answer in accordance with the lex fori."

5 Reese remarked:

> The forum must decide in each case what law shall be applied to determine the validity of a contract and the rights created thereby. There is nothing to prevent the forum from adopting a choice of law rule that the governing law shall, in the ordinary case, be that chosen by the parties.

Reese, "Power of Parties to Choose Law Governing Their Contract (1960) 54 *American Society of International Law* 49 at 51.

6 Since the Hague Convention was adopted in 1985 and first signed in 1986, it bears both dates.

conflict law. Germany, Denmark, Luxembourg, Belgium and England are amongst those European countries which have enacted statutes concerning the incorporation of the Convention into their national systems.[7] To some extent, this Convention will have an influence on the Australian legal system, because it provides new views and tendencies in contemporary conflicts of law.[8]

The 1985 Hague Convention is an attempt to harmonise the diverse applicable laws related to the international sale of goods.[9] This Convention will replace the Hague Convention on the Law Applicable to the International Sale of Goods (1955) which is currently in force in nine countries.[10] The Rome Convention and the Vienna Sales Convention had considerable influence on the drafting of the 1985 Hague Convention. This Convention was drafted consistently with the Vienna Sales Convention in such a way that by putting both conventions into force, countries will achieve a more comprehensive result. While the Hague Convention has not yet come into force, Australia may ratify it in the future.[11] As Pryles said, the contents of the Hague Convention are not unfamiliar to the Australian legal system, and even if Australia does not ratify it, its influence on Australian courts will be critical.[12]

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7 Dicey & Morris, *The Conflict of Laws* (1993) (Sweet & Maxwell, London 12th ed 1993) at 1192.

8 Because of its advanced standard in the present conflicts of law, the contents of the Rome Convention was relied on in *Libyan Arab Foreign Bank v Bankers Trust* [1989] QB 728 at 748 before April 1, 1991 when it came into force for England.

9 For an introduction to the Hague Convention see Gabor, "Emerging Unification of Conflict of Laws Rules Applicable to the International Sale of Goods" (1986) 7 *North-Western J International L and Business* 696; McLachlan, "The New Hague Sales Convention and the Limits of the Choice of Law Process" (1986) 102 *Law Quarterly Review* 591.

10 These countries are Belgium, Denmark, Finland, France, Italy, Nigeria, Norway, Sweden, and Switzerland.

11 According to Article 27, the Convention shall enter into force on the first day of the month following the expiration of three months after the deposit of the fifth instrument of ratification, acceptance, approval or accession referred to in Article 25.

12 Pryles, "The Hague Convention on the Law Applicable to Contract for the International Sale of Goods" in *Fifteenth International Trade Law Conference* (Australian Government Publishing Service, Canberra, 1988) at 354.

1. Choosing the Applicable Law

1.1. Benefits of Choosing a Law

There are a number of advantages in choosing the applicable law through inserting a choice-of-law clause into the contract. By choosing a particular legal system the parties may agree on necessary clauses and leave other details to be determined by virtue of the law chosen. Since the residual laws of the chosen legal system complete the transaction if the parties have failed to make their own provisions, the parties do not need to predict all details necessary to resolve any dispute which may arise from the contract. By choosing a law, the parties also avail themselves of a greater degree of certainty and predicability in terms of expressions used in the contract. They become able to predict the legal consequences of provisions inserted into the contract as well as the legal effects of those issues not expressly mentioned in the contract.

To choose a satisfactory law to govern the countertrade agreement, one should take into account the following key elements: i) Since courts often show more concern in cases where a law other than that of the forum is chosen, it is safer and more reliable to choose the law of the court in which a potential suit may be brought; otherwise, the parties should ensure that their choice of law will be upheld under the private international law of those jurisdictions whose courts might be competent to settle upcoming disputes. If the parties are certain that a choice-of-law term will be upheld in a particular jurisdiction, they may also incorporate a choice-of-forum clause into the contract whereby any dispute must be submitted to the exclusive jurisdiction of that particular court. ii) The legal system chosen should be the one about which the parties have adequate knowledge and confidence or such knowledge could easily be gained. Choosing a familiar law protects the parties from the consequences of poor communication and misunderstanding. iii) Since the applicable law has a gap-filling function, substantive regulations of that law must be examined carefully to ascertain whether or not they correspond with the parties' expectations and needs.

1.2. The Effect of Choosing an Applicable Law

Most legal systems recognise the principle of party autonomy in contracts by which the parties may choose the applicable law of the contract, even if some of them put certain restrictions on that choice.[13] Under the Australian legal system, contracting parties are in principle free to choose the law applicable to their contract at the time of contracting,[14] although it may be possible for the parties to select an alternative law to that previously chosen or to agree to subject the contract to a law if they have failed to make a choice at the time of contracting.[15] The position of the Australian legal system is in line with Article 7(1) of the Hague Convention which reads: "A contract of sale is governed by the law

13 Lando, "Contracts" in *International Encyclopedia of Comparative Law*, vol III(24) (1976) at 24-3; Yntema, "Autonomy in Choice of Law" (1952) 1 *American J Comparative Law* 341; Article 6 of the Vienna Sales Convention provides: "The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions." In some countries, however, all international contracts which are either concluded or performed within their territories are subject to that country's national laws. Chile and Bolivia are in this second category. Fox, *International Commercial Agreements*, (Kluwer, Deventer, the Netherlands, 2nd ed 1992) at 133; Naon, "The UN Convention on Contracts for the International Sale of Goods" in Horn & Schmitthoff (ed), *The Transnational Law of International Commercial Transactions,* vol 1 (Kluwer, Deventer, the Netherlands, 1982) at 98.

14 In *Oceanic Sun Line Special Shipping v Fay* (1988) 165 CLR 197 at 259-260, Gaudron J said:

> In general terms, the rights and obligations of parties to a contract are to be ascertained in accordance with the proper law of the contract, viz., the law which the parties intended to govern their contractual relationship.

15 *Libyan Arab Foreign Bank v Bankers Trust* [1989] 1 QB 746; Article 3(2) of the Rome Convention and Article 7(2) of the Hague Convention expressly give the parties freedom to change the law previously chosen to govern the contract. For a good discussion in English law, see Pierce, "Post-Formation Choice of Law in Contract" (1987) 50 *Modern L Rev* 176.

chosen by the parties", and with Article 3(1) of the Rome Convention providing: "A contract shall be governed by the law chosen by the parties".[16]

1.2.1. Limitations on a Choice of Law

Such a choice, however, must be bona fide and not be made in order to evade the otherwise applicable law especially if that is the law of the forum. In *Vita Food Products v Unus Shipping*, the Privy Council stated that "it is difficult to see what qualifications are possible, provided the intention expressed is bona fide and legal, and provided there is no reason for avoiding the choice on the ground of public policy".[17] In *Golden Acres v Queensland Estates*, Hoare J said:

> I am satisfied that the selection of a law other than that of Queensland was made for the specific purpose of avoiding the consequences of illegality which would or might have followed if the Queensland law applied. ... I am satisfied that the attempted selection of this law was for no other purpose than to avoid the operation of the Queensland law. Under all the circumstances, I conclude that the purported selection of the Hong Kong law was not a bona fide selection."[18]

As the ALRC Report said, the "rule in the *Vita Food* Case that a choice of law clause should be given effect to provided it was 'bona fide, legal and not contrary to public policy' is not clear".[19] Instead, the Commission recommended that "the limitations on parties' autonomy on the ground of lack of bona fides should be replaced with rules to determine when parties cannot choose to evade the operation of a mandatory law of the place of closest connection".[20] The question of being *bona fide and legal* generally arises in respect

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16 Article 42 of the Convention on the Settlement of Investment Disputes Between States and Nationals of other States, entered into force for Australia in June 1991, provides: "The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties." *Australian Treaty Series* (No 23, 1991).

17 [1939] AC 277 at 290.

18 [1969] QdR 378 at 384-385.

19 Australian Law Reform Commission (ALRC), *Choice of Law* (Report No 58, 1992) at 84.

20 At 85.

of three situations: the choice of an unconnected legal system; the choice being contrary to public policy; and the choice being against mandatory rules of the forum. These three qualifications are discussed in following paragraphs.

1.2.1.1. Having Connection with the Contract

Some legal systems require that there must be some physical or substantial connection between the jurisdiction whose legal system is chosen and the contract in respect of the subject matter, the parties or the place of performance.[21] In *Queensland Estates v Collas* a physical connection has been required for a choice of law.[22] In this regard, Campbell J remarked:

> If the parties in this clause have indicated an intention that the law of Hong Kong is to govern the whole of their contractual relations they have expressed *a choice unconnected with the realities of the contract.*[23]

In *Vita Food* the criterion is that such a choice, whatsoever it may be, must be bona fide. Although it may be argued that the choice of a legal system which has no connection with the contract is not bona fide and consequently the choice is null and void, this argument is inconsistent with the facts of *Vita Food* itself. Although in *Vita Food* the bill of lading had little connection with English law, the Privy Council said that "connection with English law

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21 In the US, for example, s1-105(1) of the Uniform Commercial Code (UCC) provides:

> when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties.

This section shows that the parties are free to choose the law of any State which has a reasonable relation with the contract. However, Article 5-1401 of the *New York General Obligations Law*, and Article 1646.5 of the *California Civil Code* require their courts to honour the choice of their laws even where the law chosen has no reasonable connection with the contract, if the agreement involves more than $250,000. See Sesser, "Choice of Law, Forum Selection and Arbitration Clauses in International Contracts: The Promise and the Reality, a US View" (1992) *International Business Lawyer* 397 at 398; Friedler, "Party Autonomy Revisited: A Statutory Solution to a Choice-of-law Problem" (1989) 37 *University of Kansas L R* 471 at 472.

22 [1971] QdR 75.

23 [1971] QdR 75 at 80-81 [emphasis added].

is not as a matter of principle essential".[24] It is to be noted that in this case there was a reasonable basis for selecting English law because, as Lord Wright said, it is a common practice in international business to select English law even in cases where the parties are not residents in the UK and the transaction is to be carried out completely outside England.[25] As a result, if there is no connection between the contract and the jurisdiction whose law is chosen, a reasonable basis for that choice may be sufficient; for example, the parties have selected an unconnected legal system to avail themselves of advantages of a neutral or developed legal system.

It should be noted, however, that in *Vita Food* and *British Controlled Oilfields v Stagg*,[26] the law chosen was the law of the forum which had no substantial connection to the contract. In cases where the contract has a substantial connection with the forum and the parties have selected an unconnected law, the court may not uphold such a choice, as occurred in *Queensland Estates v Collas*.[27/1] As a result, if a case is submitted to an Australian court, the choice of Australian law will be upheld if even the contract has little connection with Australia. On the other hand, if the contract has a substantial connection with Australia and the parties have chosen an unconnected law, the Australian court may disregard such a choice on the basis of its not being bona fide.[27/2] In both the Rome

24 [1939] AC 277 at 290.

25 As above.

26 In *British Controlled Oilfields v Stagg* [1921] WN 319, Ernesto Stagg, a citizen of the Republic of Ecuador and a Canadian company, with an office in London, entered into a contract in New York. They inserted into their contract a provision saying that "it shall be considered and held to be one duly made and executed in London" which was construed by the court that the parties had chosen English law to govern the contract. In reply to the argument that the contract in question was not made within the English jurisdiction, Sargant J remarked that because the parties intended to provide that the contract would have the same legal effect as if it had been made in London, the contract should be governed by English law. At 319.

27/1 [1971] QdR 75.

27/2 In *BHP Petroleum v Oil Basing* [1985] VR 725 at 747-748, however, Murray J indicates that "the parties are free to choose the law which shall govern their agreement".

Convention and the Hague Convention, the parties may choose a legal system even if there is no connection between the law chosen and the contract.[28]

1.2.1.2. Public Policy

Public policy is a common ground on which a choice of law may be overridden. As Lord Wright said in *Vita Food*, the freedom of the parties to select the law governing the contract is not an absolute freedom; rather it is conditional on not being contrary to public policy.[29] The issue of public policy generally arises when a legal system other than the forum is selected. It is unlikely that an Australian court would invalidate a choice of Australian law on account of public policy of the countries with which the contract has substantial links. Overriding a choice-of-law clause on the grounds of public policy is consistent with both the Hague and Rome Conventions. Article 18 of the Hague Convention reads: "The application of a law determined by the Convention may be refused only where such application would be manifestly incompatible with public policy (ordre public)". Article 16 of the Rome Convention provides: "The application of a rule of the law of any country specified by this Convention may be refused only if such application is manifestly incompatible with the public policy ('ordre public') of the forum." As a result, public policy is a ground on which a choice of law may be rejected.

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28 See Article 3(1) of the Rome Convention and Article 7(1) of the Hague Convention.

29 *Vita Food Products v Unus Shipping* [1939] AC 277 at 290.

1.2.1.3. Mandatory Regulations

In addition to public policy, a court may disregard a choice of law because of its inconsistency with mandatory rules of the forum enacted for socio-economic purposes.[30] In *Golden Acres v Queensland Estates* the court rejected the choice of Hong Kong law as the law of contract on the basis of its inconsistency with mandatory rules of Queensland.[31] The Hague and Rome Conventions also permit a court to avoid a choice of law because of mandatory provisions of the forum. Article 17 of the Hague Convention provides: "The Convention does not prevent the application of those provisions of the law of the forum that must be applied irrespective of the law that otherwise governs the contract." Similarly, Article 7(2) of the Rome Convention reads: "Nothing in this Convention shall restrict the application of the rules of the law of the forum in a situation where they are mandatory irrespective of the law otherwise applicable to the contract."

These mandatory rules are generally in areas of protecting weaker parties, consumers, employers and insured persons or are related to cases where a law other than the forum is chosen to circumvent taxes or other financial regulations of the forum. For example, consumer protecting measures adopted by the *Trade Practices Act* 1974 (Cth) are mandatory rules which cannot be circumvented through choosing a different law.[32] A

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30 *Kay's Leasing v Fletcher* (1964) 116 CLR 124 at 143-144.

31 *Golden Acres v Queensland Estates* [1969] QdR 384; *Freehold Land Investments v Queensland Estates* [1970] 123 CLR 418; and *Queensland Estates v Collas* [1971] QdR 75.

32 Section 67 of the *Trade Practices Act* provides:

> Where
> (a) the proper law of a contract for the supply by corporation of goods or services to a consumer would, but for a term that it should be the law of some other country or a term to the like effect, be the law of any part of Australia; or
> (b) a contract for the supply by a corporation of goods or services to a consumer contains a term that purports to substitute, or has the effect of substituting, provisions of the law of some other country or of a State or Territory for all or any of the provisions of this Division,
> this Division applies to the contract notwithstanding that term.

similar provision can be found in the *Insurance Contracts Act* 1984 (Cth) in respect of supporting the insured party.[33] Section 17(3) of the *Contracts Review Act* 1980 (NSW) also permits the courts to set aside a choice of law for the purposes of judicial review of the contract and granting relief in respect of harsh, oppressive, unconscionable or unjust contracts.[34] Another example is section 11(1) of the *Carriage of Goods by Sea Act* 1991 (Cth) which provides that all parties to a bill of lading or a similar document of title, relating to the carriage of goods from any place in Australia to any place outside Australia, are taken to have intended to contract according to the laws in force at the place of shipment notwithstanding any agreement to the contrary.[35] It is to be noted that a choice of law other than Australia's will be rejected on the grounds of these mandatory rules if the contract has a real connection with Australia.

A question arises whether Australian courts may reject a choice of law on the basis of contradiction with mandatory rules of other countries with which the contract has a substantial connection. Article 7(1) of the Rome Convention prescribes that "effect may be given to the mandatory rules of the law of another country with which the situation has a

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33 Section 8 of the *Insurance Contracts Act* 1984 (Cth) provides:

> (1) Subject to section 9, the application of this Act extends to contracts of insurance and proposed contracts of insurance the proper law of which is or would be the law of a State or the law of a Territory in which this Act applies or to which this Act extends.
> (2) For the purposes of subsection (1), where the proper law of a contract or proposed contract would, but for an express provision to the contrary included or to be included in the contract or in some other contract, be the law of a State or of a Territory in which this Act applies or to which this Act extends, then, notwithstanding that provision, the proper law of the contract is the law of that State or Territory.

In this regard see *Akai v the People's Insurance Company* (1996) 71 ALJR 156.

34 Section 17 of the *Contract Review Act* reads:

> This Act applies to and in relation to a contract only if:
> (a) the law of the State is the proper law of the contract;
> (b) the proper law of the contract would, but for a term that it should be the law of some other place or a term to the like effect, be the law of the State; or
> (c) the proper law of the contract would, but for a term that purports to substitute, or has the effect of substituting, provisions of the law of some other place for all or any of the provisions of this Act, be the law of the State.

35 Other mandatory rules include: *Credit Act* 1984 (NSW), s3(1); *Consumer Transactions Act* 1972 (SA), s6; *Credit Act* 1984 (VIC), s3(1); and, *Industrial Arbitration Act* 1940 (NSW), s88f.

close connection, if and in so far as, under the law of the latter country, those rules must be applied whatever the law applicable to the contract". When Australian law is chosen by the parties, the courts in Australia may not displace a choice of Australian law by giving effect to the mandatory rules of a country with which the contract has a substantial connection.[36] However, if the parties intend to circumvent the exchange control or other import-export regulations of a country having a good relationship with Australia, the court may disregard such a choice.[37] In cases where a law other than the Australian law is chosen, and the contract has a substantial link with a third jurisdiction, it is not clear as to whether the court disregards the law chosen because of mandatory rules of a third jurisdiction having a real connection with the contract. The Australian Law Reform Commission has recommended that mandatory rules of a jurisdiction having a real and substantial link with the contract should be considered, irrespective of whether Australian law is chosen or not.[38]

1.2.2. A Split Choice of Law

Although selecting a single law to govern all aspects of contractual relationship is generally more convenient to the parties, in certain situations they may choose to select a law to govern part of the contract. A question arises as to whether they may select two or more laws governing different parts of the contract. The Rome Convention permits the parties to "select the law applicable to the whole or a part only of the contract".[39] In cases where

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36 *Vita Food Products v Unus Shipping* [1939] AC 277 at 296.

37 *Foster v Driscoll* [1929] 1 KB 470; *Regazzoni v Sethia* [1958] AC 301.

38 The Australian Law Reform Commission has recommended:

> Where the objective law of the contract is the law of an overseas place which has mandatory legislation which applies to a question arising under a contract and which cannot be excluded by the operation of choice of law rules a majority of the Commission recommends that the question may be decided in accordance with the legislation of that place.

Australian Law Reform Commission (ALRC), *Choice of Law* (Report No 58, 1992) at 93.

39 Article 3(1).

there is no express choice, the Rome Convention also prescribes that "a severable part of the contract which has a closer connection with another country may by way of exception be governed by the law of that other country."[40]

Commentators have generally assumed that these two articles indicate the freedom of parties to choose two or more laws for different aspects of a contract.[41] However, it could be argued that Article 3(1) only permits the parties to select a law either for the whole contract or for a part of it. It does not indicate that the parties may select two applicable laws for different parts of a contract. This understanding might be supported by Article 7 of the Hague Convention which provides: "Such a choice may be limited to a part of the contract". Thus, in cases where the parties select the applicable law only for a part of the contract, it is up to the forum to determine which law is applicable to the rest of the contract. What is certainly clear from these provisions is that parties can limit their choice to a part of the contract and courts may apply more than one law to different parts of a contract. Nevertheless, the alternative case could be put that if it is possible for a contract to have a split proper law,[42] why is it not possible for the parties to choose different laws to govern different aspects of their contract?[43]

In Australia, it is clear that if a contract is actually composed of two or more contracts, each contract can have its own governing law. But as Lord MacDermott said in *Kahler v Midland Bank*, "it is doubtless true to say that the courts of this country will not split the

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40 Article 4(1).

41 Dicey & Morris, *The Conflict of Laws* (1993) (Sweet & Maxwell, London 12th ed 1993) at 1207; Collier, *Conflict of Laws*, (Cambridge University Press, Cambridge, 1994) at 188.

42 *Libyan Arab Foreign Bank v Bankers Trust* [1989] QB 728 at 747.

43 This issue that the parties can choose different laws for different aspects of a contract is recognised by English Common Law. In *Forsikringsaktieselskapet Vesta v Butcher and others* [1986] 2 All ER 488 at 504, Hobhouse J held: "But by the same logic the choice of law is a matter for the actual or imputed choice of the parties and it has been recognised for a long time that parties may choose that different parts of the contract should be governed by different laws."

contract in this sense readily or without good reason".[44] The assumption that only one law may govern a contract has been endorsed in *Wanganui-Rangitikei Electric Power Board v Australian Mutual Provident Society*, where Evatt J said that "the whole theory which lies at the root of private international law, however difficult that theory may be in application, is that the law of one country, *and one country alone*, can be the proper or governing law of the contract".[45] Nevertheless, with respect to the Rome Convention, the Hague Convention and recent UK decisions in which the possibility of choosing different laws for different parts of a contract is recognised, Australian courts may also recognise such a possibility.

1.3. Some Considerations in Choosing a Law

The following issues should also be considered when an express choice of law is to be made:

i) In federal countries such as the US, Canada and Australia, there are generally two kinds of laws, federal and state laws. In addition to federal regulations which are in force throughout Australia, each state and territory may have its own regulations. Since there are few differences between the states in Australia in respect of contract law, the issue of conflict-of-law within Australia is usually overlooked.[46] However, to avoid any uncertainty about rules that will be applied to a countertrade contract, it is advisable to specify the law of a specific state or territory, such as New South Wales, Victoria or South Australia.

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44 [1950] AC 24 at 42; see also *Samarni v Williams* [1980] 2 NSWLR 389 at 395.

45 (1934) 50 CLR 581 at 604 [emphasis added].

46 Hayne, "Problems With Long Term Contracts: Conflict of Laws" (1986) *Australian Mining and Petroleum Law Association Yearbook* 467 at 467.

While the choice of 'Australian law' as the proper law of the contract is not free from uncertainty, foreign traders may hesitate to submit their contracts to the law of a particular state or territory. This difficulty has been well raised by the Australian Law Reform Commission saying:

> a cross border transaction which provides that the proper law of the contract is to be 'Australian law' opens up a considerable areas of uncertainty. From the point of view of foreign commercial interests, there is a very natural hesitation in entering into a contract which provides that the proper law of the contract shall be, for example, the law of Tasmania or the law of the Northern Territory or the law of NSW, although, if uncertainty is to be avoided, there is no escape from observing this degree of precision.[47]

Following the example of Germany in dealing with a similar problem, the Commission has recommended that "[t]he Attorney General should review, as a matter of priority, the proposal that there should be clarification of the meaning of a choice of 'Australian law' ... in a cross border contract".[48]

ii) In cases where the parties stipulate a choice of law, a question arises as to whether they have intended the law as it exists at the time of contracting or at the time of suit if a change has occurred to the applicable law after concluding countertrade contracts.[49] It is generally presumed that the parties have intended to apply the law to their relationship 'as it exists from time to time'.[50] To avoid possible undesirable consequences of subsequent changes in the applicable law, it is advisable to express in the contract that law means the law in force at the time of contracting. The parties may also incorporate some provisions of a given law

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47 The Australian Law Reform Commission, *Legal Risk in International Transactions* (Report No 80, 1996) at 88.

48 At 89.

49 In England, it is clear that the law at the time of suit is applicable to the contract. Lowe, "Choice of Law Clauses in International Contracts: A Practical Approach" (1971) 12 *Harvard International Law J* 1 at 20.

50 *Re Claim by Helbert Wagg* [1956] Ch 323 at 338.

in the contract which certainly constitutes a part of the contract and must be construed as it was at the time of incorporating and in the light of the applicable law.[51]

iii) A reference to the rules of a given country may be construed as a reference to the whole legal system including its conflicts law rules. In some standard contracts in Russia, for example, Swedish rules of law have been chosen to govern the contract in order to take advantage of its conflict-law rules which refer the case back to Russian law as the law of the buyer, or of the place of formation or performance.[52] Since in the Anglo-Australian legal system the concept of renvoi[53] is not recognised in respect of contracts, choosing a law means referring to substantive rules of that legal system.[54] The Hague Convention, Article 15 provides: "In the Convention 'law' means the law in force in a State other than its choice of law rules". Similarly Article 15 of the Rome Convention provides: "The application of the law of any country specified by this Convention means that application of the rules of

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51 For a general distinction between reference to a law and incorporation of some provisions into a contract see Dicey & Morris, *The Conflict of Laws* (1993) (Sweet & Maxwell, London 12th ed 1993) at 1222; it should be noted that the incorporation of some or all rules of a particular law by no means substitutes for the identification of a proper law. For a good discussion about different legal effects of a choice of law and incorporation by reference within the Anglo-Australian context, see Kelly, "Reference, Choice, Restriction and Prohibition" (1977) 26 *International & Comparative L Q* 857.

52 Heath, "Sales of Industrial Goods to the USSR; An Analysis of Standard Russian Forms of Agreement" (1976) 17 *Harvard International Law J* 71 at 74.

53 For a general discussion about renvoi see Dicey & Morris, *The Conflict of Laws* (1993) (Sweet & Maxwell, London 12th ed 1993) at 1204.

54 *Re United Railways of Havana and Regla Warehouses* [1960] 1 Ch 52 at 96-97; In *Amin Rasheed Shipping v Kuwait Insurance* [1984] AC 50 at 61-62, Lord Diplock said that the proper law of a contract

> is the substantive law of the country which the parties have chosen as that by which their mutual legally enforceable rights are to be ascertained, but excluding any renvoi, whether of remission or transmission, that the courts of that country might themselves apply if the matter were litigated before them. For example, if a contract made in England were expressed to be governed by French law, the English court would apply French substantive law to it notwithstanding that a French court applying its own conflict rules might accept a renvoi to English law as the lex loci contracts if the matter were litigated before it. Conversely, assuming that under English conflict rules English law is the proper law of the contract the fact that the courts of a country which under English conflict rules would be regarded as having jurisdiction over a dispute arising under the contract (in casu Kuwait) would under its own conflict rules have recourse to English law as determinative of the rights and obligations of the parties, would not make the proper law of the contract any the less English law because it was the law that a Kuwaiti court also would apply.

law in force in that country other than its rules of private international law". However, it is advisable to express in the contract that law means domestic law other than of conflict law rules to avoid the possibility of renvoi to the law of another country.

iv) In some cases, the parties stipulate an ambiguous choice-of-law clause which may lead to unexpected results. The contract may refer to 'international norms', 'principles of law of civilised nations', 'common principles of national laws of the parties, or 'principle of good will or good faith' which may be invalidated or interpreted differently in various jurisdictions. For example, in *Texaco v Libyan Arab Republic*, the contract had a provision in respect of applicable law as follows:

> The Concession shall be governed by and interpreted in accordance with the principles of law of Libya common to the principles of international law and in the absence of such common principles, then by and in accordance with the general principles of law, including such of those principles as may have been applied by international tribunals.[55]

The following words of the arbitrator in this connection show the likely divergent interpretations of such provisions:

> In the present dispute, general principles of law have a subsidiary role in the governing law clause and apply in the case of lack of conformity between the principles of Libyan law and the principles of international law; but precisely the expression 'principles of international law' is of much wider scope than 'general principles of international law', because the latter contribute with other elements (international custom and practice which is accepted by the law of nations) to constitute what is called the 'principles of international law'.[56]

It is clear that the tribunal has given two different meanings to 'principles of international law' and 'general principles of international law', although it has given no precise distinction between them. As a result, ambiguous words may be construed differently by different persons.

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55 (1979) 53 ILR (International Law Report) 389 at 442.
56 At 452.

2. Silence on the Applicable Law

If the parties fail to agree on a choice-of-law clause and a dispute is brought before a court or tribunal, first it is necessary to determine the proper law of the contract. The court generally applies its own conflict-of-law rules to determine the governing law of the agreement. Since conflict-of-law rules may vary from jurisdiction to jurisdiction, the outcome may not always be the same. As a result, a contracting party may bring the case to a jurisdiction the law of which is more advantageous, so as to benefit from the substantive rules of a legal system which will be determined by the court as the law of the contract.[57] One method in controlling forum shopping is to agree on an exclusive jurisdiction clause submitting all disputes to the exclusive jurisdiction of a specific country. The limitation of this method is that a court, other than that agreed on, may not give the chose exclusive operation, even though the parties have agreed on the exclusive jurisdiction of another court.[58] As a result, the better choice for the contracting parties is to agree on an express choice-of-law clause.

In the absence of an express choice of law, the applicable law is the law which is intended by the parties.[59] In cases where such an intention is not clear, Australian courts determine

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57 For a discussion about forum-shopping see Guthrie, "'A Good Place to Shop': Choice of Forum and the Conflict of Laws" (1995) 27 *Ottawa Law Review* 201; Juenger, "What's Wrong with Forum Shopping" (1994) 16(3) *Sydney Law Review* 5; Opeskin "The Price of Forum Shopping" (1994) 16(3) *Sydney Law Review* 14.

58 In *Akai v the People's Insurance Company* (1996) 71 ALJR 156, an exclusive jurisdiction clause to refer all disputes to the courts of England has not been considered to be operating "to exclude the jurisdiction of the Supreme Court of New South Wales, although it may constitute a ground for that Court to refuse to exercise its jurisdiction". At 170. See also *Compagnie des Messageries Maritimes v Wilson* (1954) 94 CLR 577 at 586-587, 589 and *Oceanic Sun Line Special Shipping Company v Fay* (1988) 165 CLR 197 at 259. See also Zaphiriou, "Choice of Forum and Choice of Law Clauses in International Commercial Agreements" (1978) 3(2) *International Trade L J* 311 at 315.

59 *Mount Albert Borough Council v Australian Temperance and General Mutual Life Assurance Society* [1938] AC 224 at 240; *Vita Food Products v Unus Shipping* [1939] AC 277 at 290; *Whitworth Street Estates v Miller* [1970] AC 583 at 591ff.

the applicable law through identifying the legal system with which the contract has "the closet and most real connection".[60] This test gives the courts freedom to select the applicable law through considering all surrounding circumstances. A similar test can be found in Article 4(1) of the Rome Convention which provides that "the contract shall be governed by the law of the country with which it is most closely connected". Since the concept of 'closest connection' may be somewhat imprecise, Article 4(2) presumes "that the contract is most closely connected with the country where the party who is to effect the performance which is characteristic of the contract has .. his habitual residence... or central administration". By comparison, the Hague Convention provides less flexibility as to determining the applicable law by ascertaining the law of the seller, and in certain situations the law of the buyers, as the applicable law. A reference to the general concept of 'closest connection' has been made only by way of exception.[61]

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60 The phrase 'closest and most real connection' is drawn from the statement of Lord Simonds in *Bonython v the Commonwealth* (1950) 81 CLR 486 at 498.

61 Article 8 of the Hague Convention provides:

> (1) To the extent that the law applicable to a contract of sale has not been chosen by the parties in accordance with Article 7, the contract is governed by the law of the State where the seller has his place of business at the time of conclusion of the contract.
> (2) However, the contract is governed by the law of the State where the buyer has his place of business at the time of conclusion of the contract, if:
> (a) negotiations were conducted, and the contract concluded by and in the presence of the parties, in that State; or
> (b) the contract provides expressly that the seller must perform his obligation to deliver the goods in that State; or
> (c) the contract was concluded on terms determined mainly by the buyer and in response to an invitation directed by the buyer to persons invited to bid (a call for tenders).
> (3) By way of exception, where, in the light of the circumstances as a whole, for instance any business relations between the parties, the contract is manifestly more closely connected with a law which is not the law which would otherwise be applicable to the contract under paragraphs 1 or 2 of this Article, the contract is governed by that other law.
> (4) Paragraph 3 does not apply if, at the time of the conclusion of the contract, the seller and the buyer have their places of business in States having made the reservation under Article 21 paragraph 1 sub-paragraph b.
> (5) Paragraph 3 does not apply in respect of issues regulated in the United Nations Convention on contracts for the international sale of goods (Vienna, 11 April 1980) where, at the time of the conclusion of the contract, the seller and the buyer have their places of business in different States both of which are Parties to that Convention.

3. Barter and the Applicable Law

Barter is a straight exchange of goods for goods under a single contract with no money involved. In choosing a proper law to govern a barter contract, it should be borne in mind that different jurisdictions may deal with barter differently. In some jurisdictions a barter agreement is a sale contract. Thus, sale regulations, whatever they may be, also apply to barter deals.[62] In some jurisdictions, sale regulations do not cover barter arrangements. Rather, contractual aspects of barter are regulated by virtue of general principles of contract law or particular rules exclusive to barter deals. In Australia, since the *Sale of Goods Acts*, which are in force in various States and Territories, do not cover barter deals, the issues arising from barter arrangements are to be settled by means of common law. As a result, prior to choosing a law, an investigation should be made into whether there are specific rules applying only to barter and, if so, to what extent they satisfy the parties' needs in an international context. In cases where sale rules cover barter deals, consideration should be given as to whether these rules suit barter deals of a reciprocal nature. If some of the sale regulations are not well fitted to their needs, the parties should insert appropriate provisions into the barter deal to change or amend the effects of those rules corresponding to their needs. If the parties wish to choose the Vienna Sales Convention as the applicable law of the contract it is advisable to express such a choice.[63]

It is safer and more convenient to select one law to govern a barter contract as a whole. Selection of a law to govern the transfer of goods in one direction and another law to govern the transfer of goods in the other direction might create difficulties as to whether

62 See Chapter 5, pages 174ff.

63 More discussion about the Vienna Sales Convention is in the next Chapter.

what has been done amounts to performance, whether a party may be discharged as a result of frustration, or whether the aggrieved party has a right to terminate or withhold performance on the grounds of the other party's breach.[64] In these circumstances, it is possible for a court to invalidate such a choice of law, displacing in favour of the lex fori, or the law chosen by the lex fori, on account of ambiguity. Alternatively, a court may also view such a split in governing law as an indication of two separate contracts in which the prices have been set off. This splitting may create unpleasant consequences for the parties intending to enter into a linked transaction rather than two separate sale contracts. Since a barter deal is generally viewed as a single contract under which certain goods in one direction are to be exchanged for some other goods in another direction and not as two separate contracts, choosing two laws for two sides of a deal is certainly both ambiguous and inconvenient.

4. Counterpurchase and the Applicable Law

Under a counterpurchase arrangement, an exporter undertakes to counter-purchase some unrelated goods from the importer. There are at least two separate contracts, a sale contract for the initial export and a protocol as a framework for the whole arrangement. In many cases, there is also a third contract under which the initial exporter counter-imports certain goods from the importer in the light of the protocol. It is possible to choose one single law to govern these contracts or a different law for each contract. The issue of whether one single law should be chosen for all contracts or different laws for different contracts is a matter of the parties' expectations and needs to be examined on a case-by-

64 *Wanganui-Rangitikei Electric Power Board v Australian Mutual Provident Society* (1934) 50 CLR 581 at 604.

case basis. In terms of consistency, a single law is preferred because all questions and disputes arising between the parties are to be settled in the light of one legal system, avoiding opposing outcomes as a result of applying different legal systems.

The following hypothetical example may illustrate the importance of a single law for all contracts. An Austrian company enters into a counterpurchase agreement with Thailand under which the company must export particular goods to Thailand and in return to counter-purchase Thai rice up to 80 percent of the first sale value. Two contracts are drafted in such a way that each contract contains a provision linking it to the other contract. The Austrian legal system is chosen for the export contract of Austrian goods to Thailand and Thai law is chosen to govern the counter-purchase contract of Thai rice. While in Austria such contracts may be perceived as a barter contract rather than two separate contracts of sale,[65] in Thailand these contracts are viewed as two sale contracts. If a dispute is brought before an Austrian court, the court may view the second contract as part of a single entity and subject it to the rules of barter. This interpretation might be contrary to Thai party's expectation and desire in separating the contract and subjecting it to the Thai legal system.

Nevertheless, the parties may wish to choose different legal systems for different contracts to avail themselves of potential advantages which a legal system has in respect of certain aspects of the contract. Each party may wish to choose its own legal system as the proper law of its own export if an agreement on a single legal system has not been reached. The choice of different legal systems for various contracts may also be justified because such a choice might not be upheld in a jurisdiction because the contract has a substantial

65 Loeber, "Barter Trade - An Austrian View" in Lafili (ed), *Survey of the International Sale of Goods* (Kluwer, Deventer, the Netherlands, 1986) at 304.

connection with a different legal system. As a result, the legal system of the country with which the respective contract has a substantial connection may be chosen for each contract.

The parties to a counterpurchase arrangement may prefer to avoid an express choice of law for all contracts or for a specific one. There are a number of reasons underlying such a decision. One reason is that the trade relationship between the parties may be so trusting and cooperative that they do not want to distort their relations by unnecessary friction over the law of the contract. In such climates, the relationship is so highly valued that it is hardly expected that any dispute would lead to a lawsuit to necessitate determining the applicable law, particularly when the significance of the contract is not great relative to the whole relationship. Another reason for ignoring an express choice of law is the parties' presumption that the contract is so precisely detailed that any potential disagreement can be settled in the light of the contents of the contract.[66] In some cases where the parties cannot agree over the law of the contract, they may prefer to leave the applicable law unmentioned. In these situations, they may wish to avoid difficulties of such complete uncertainty through limiting the governing law to particular countries, say one of the EEC Members or to those counties with a developed commercial law.[67] If the agreement provides that the governing law is that legal system which will be chosen later by one of the parties, Australian courts may disregard such a choice, especially if the law chosen has no substantial connection with the contract.[68]

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66 Lowe, "Choice of Law Clauses in International Contracts: A Practical Approach" (1971) 12 *Harvard International Law J* 1 at 2.

67 Fox, *International Commercial Agreements*, (Kluwer, Deventer, the Netherlands, 2nd ed 1992) at 133.

68 *Armar Shipping Co v Caisse Algerienne d'Assurance* [1980] 2 Lloyd's Rep 450; *Iran Vojdan* [1984] 2 Lloyd's R 380. In *Iran Vojdan*, Bingham J said:

> The proper law is something so fundamental to questions relating to the formation, validity, interpretation and performance of a contract that it must, in my judgement, be built into the fabric of the contract from the start and cannot float in an indeterminate way until finally determined at the option of one party.

5. Buy-backs and Offsets and the Applicable Law

Buy-back and offset deals can be classified as long-term and complex arrangements which perhaps involve a number of various contracts, such as sale of goods, transfer of technology, know-how and the licence, international distributorship, planning and constructing, exploring of oil, gas and minerals, investment, or industrial co-operations. Each contract should have a choice-of-law clause determining the governing law, preferably a single legal system with which the parties are familiar and sufficiently developed to handle appropriately complex transactions. The absence of an express choice of law is preferred to choosing an undeveloped law because most of these contracts have been elaborated by businesses in an environment different from the traditional notion of contract law which may prevail in a jurisdiction.[69] With respect to implementation of various contracts packaged in a buy-back or offset program which may involve different participants, the parties may wish to divide the package into identifiable components such as technology transfer, sale of goods, the contract between contractor and subcontractors. The parties to each identifiable component may wish to choose a governing law which is more compatible with their particular needs but perhaps differs from others.[70] Inconsistency in outcomes as a result of applying different laws to various components and disregarding the economic or technical unity of the project are, however, two disadvantages of this approach. With respect to the law applicable to these contracts, the following points should be considered:

At 385. See also Danilowicz, "'Floating' Choice-of-Law Clauses and Their Enforceability" (1986) 20 *International Lawyer* 1005.

69 Wigley & Lawton, "International Mineral Development Arrangements" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 149.

70 Delaume, *Transnational Contracts: Applicable Law and Settlement of Disputes,* vol 1 (Oceana Publication, New York, 1988) at 10-11.

i) if one party to many of the above contracts is a government or government agency, it often insists on its own national law as the governing law.[71] In these cases if the law in question is not adequately developed to cover various questions arising from the contract, it is a positive factor to negotiate this issue with the related governmental agency. If it insists on its own law, an alternative way is to draft the contracts in a way so detailed that little space will be left to the applicable law for manoeuvre.

ii) Some countries subject some of the above contracts to their own domestic law, irrespective of the law chosen as the proper law if a suit is submitted to their courts. In China, for example, if buy-back or offset is carried out through a joint venture, the Chinese legal system will apply to the contracts.[72] As another example, if buy-back or offset has involved a transfer of technology of US origin, the US law is the proper law of the contract if a suit is brought before US courts, irrespective of the law chosen by the parties.[73] Some countries subject these arrangements to their national laws if the parties fail to agree on a different legal system. As a result, if the parties are not satisfied with that law, they need to express a different law in their contract. It should be noted that although it is more convenient for a party to choose its own national legal system, a foreign law may be more supportive, affording greater protection to the party in respect of particular aspects of the contract.[74]

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71 Horn, "Uniformity and Diversity in the Law of International Commercial Contracts" in Horn & Schmitthoff (ed), *The Transnational Law of International Commercial Transactions*, vol 1 (Kluwer, Deventer, the Netherlands, 1982) at 10; Stokes, *International Construction Contracts* (McGraw-Hill Publications Company, New York, 1981) at 36.

72 Baxter, "International Conflict of Laws and International Business" (1985) 34 *International & Comparative Law Q* 538 at 541-542.

73 Lloyd, "Technology and the Law: Oil Shale Projects" (1986) *Australian Mining and Petroleum Law Association Yearbook* 522 at 531.

74 In the US, for example, licensee estoppel with respect to patents is unenforceable, but it is enforceable in Japan. Cable, "International Distribution Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 69.

iii) Since a buy-back or offset package may have a number of contracts from labour to investment and technology transfer, different countries may have their own compulsory rules applying to the contract in question, regardless of the law chosen by the parties. For example, international construction contracts are subject to a number of compulsory rules of the place where the works are to be carried out.[75] Similarly, if under a buy-back arrangement a field of oil or mineral is to be exploited, there are many mandatory regulations in the host country applying to the agreement. These mandatory rules include environmental law, acquisition, use of the foreign labour, provisions on working conditions, work safety, export, import, foreign exchange restrictions, customs duties, taxes and so on. As a result, in drafting such contracts the parties should consider these mandatory rules which have significant effects on the performance of the obligations or on the outcome of a trial if a dispute arises.

iv) Offset and buy-back programs are complex and of a long-term nature. As a result, during the performance of the agreement a number of decisions may need to be taken prior to further action. In the case of any disagreement between the parties, courts or tribunals will try to settle the issue in the light of the applicable law. As a result, through a choice of law the parties maintain a reasonable expectation in respect of issues arising from the agreement over the life of the contract. Since the rules of the legal system chosen to govern buy-back or offset contracts may be changed over the life of the contracts, the parties should agree on whether they have intended to apply the law in force at the time of contracting or at the time of disputes.

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75 Westring, "Construction and Management Contracts" in Horn (ed), *The Transnational Law of International Commercial Transactions*, vol 1 (Kluwer, Deventer, the Netherlands, 1982) at 181.

v) When a government or a governmental agency is a party to a long-term buy-back or offset arrangement and its national law has been chosen to govern the arrangement, it is a possibility that the country may pass a retrospective law discharging or modifying the obligations under the arrangement. To safeguard against such changes, the law as it exists at the time of contracting should be emphasised.[76] If the suit is brought before a different jurisdiction, such retrospective legislation may be considered by the court. In *Adams v National Bank of Greece*, Lord Reid said that "there is no general rule that English law will not give effect to foreign retrospective legislation".[77] Thus, in the Anglo-Australian legal system courts may give effect to such legislation, unless it aims at harming specific persons.

vi) When a party to a buy-back or offset arrangement has to enter into a sub-contract with a third party, it is in the best interest of the party if the applicable law for the main agreement and the sub-agreement is the same. Where two different laws are chosen, it is possible, for example, that under the main agreement the party may bear greater liability with respect to a failure to perform than the party can compensate under the sub-contract.[78]

Conclusion

In international trade, the rights and obligations of the countertrading parties are generally detailed in written documents. Since the provisions and expressions used in these documents are to be construed by reference to a legal system, their contents should be

76 Berg, *Drafting Commercial Agreements* (Butterworths, London, 1991) at 178.

77 [1961] AC 255 at 283; Dicey & Morris, *The Conflict of Laws* (1993) (Sweet & Maxwell, London, 12th ed 1993) at 1266; Hayne, "Problems With Long Term Contracts: Conflict of Laws" (1986) *Australian Mining and Petroleum Law Association Yearbook* 467 at 473.

78 *ECE Guide on Drawing up Contracts for Large Industrial Works* (1973) Para 46; reproduced in Delaume, *Transnational Contracts: Applicable Law and Settlement of Disputes* (Oceana Publication, New York, 1988) Appendix IV, Booklet D.

drafted in the light of the governing law. The impact of the governing law on the parties' rights and obligations is also significant in terms of those issues not agreed in the contract because the applicable law also has a gap-filling function which completes the contracts if the parties fail to otherwise agree. As a result, drafting a countertrade contract in the light of the applicable law provides greater certainty as to the effects and consequences of the contract. The principle of party autonomy in choosing the applicable law is widely recognised in various jurisdictions, although certain limitations may be imposed on such a choice from time to time. A choice-of-law clause may be accompanied by a dispute resolution clause to achieve greater certainty and convenience if a dispute arises. The dispute resolution clause may provide for the settlement of any disputes by litigation in an exclusive jurisdiction or through arbitration.[79]

The choice-of-law issue is more significant in respect of countertrade contracts because countries generally have no specific rules for countertrading and consequently disputes are to be settled by reference to sale of goods law or through general principles of contract law. Since the parties may need to provide detailed provisions as to contractual aspects of their countertrade contracts, they wish to ensure that they will be honoured and appropriately construed if a dispute arises. Although for the sake of consistency a single legal system to govern all contracts of a countertrade package is preferred, different legal systems may be chosen for various contracts if considering all the surrounding circumstances such a split is beneficial.

79 For commercial arbitration in Australia, see generally Pryles, "Australia" in *International Handbook on Commercial Arbitration* (Kluwer, the Hague, 1996) Section 'Australia'.

CHAPTER 5

The Vienna Sales Convention and Countertrade

Introduction

The United Nations Convention on Contracts for the International Sale of Goods (the Vienna Sales Convention) provides uniform rules as to the formation and operation of international sales contracts. Since the Convention has been adopted by many countries and it seems likely that more countries will do so, it plays a key role in regulating contracts for international sales of goods. It is therefore important for countertraders to determine the circumstances in which the Convention applies to their contracts and to recognise its effects on the rights and obligations of countertrading parties. This Chapter examines the scope of the Convention in order to determine whether or not it covers countertrade contracts. The analysis begins with a general outline of the Convention which might be useful in understanding its effects on international contracts. Following these general remarks, the application of the Convention to barter, counterpurchase, buy-back and offset will be analysed.

1. General Remarks

The preamble to the Vienna Sales Convention provides that the adoption of uniform rules which govern international sales contracts "would contribute to the removal of legal barriers in international trade and promote the development of international trade".[1] The Convention has been designed to replace two Conventions relating the *Uniform Law on the International Sale of Goods* (Hague 1964), and to *Uniform Law on the Formation of Contracts for the International Sale of Goods* (Hague 1964)[2] both of which failed to gain world-wide acceptance.[3] Unlike its predecessors, the Vienna Sales Convention has received widespread support from both developed and developing countries. At the time of writing, forty-eight countries have acceded to or ratified the Convention. Australia was the 16th party.[4] The Convention came into effect on 1 January 1988. In Australia, the Convention

1 The preamble to the Vienna Sales Convention. A copy of the Convention can be found in *Australian Treaty Series* (No 32, 1988).

2 These two Conventions came into force in August 1972 when five States deposited their ratification and they are currently in force. Murphy, "United Nations Convention on Contracts for the International Sale of Goods: Creating Uniformity in International Sales Law" (1989) 12 *Fordham International L J* 727 at 734. However, some of these countries have denounced these Conventions in favour of the Vienna Sales Convention. *Chitty on Contracts*, vol II (Sweet & Maxwell, London, 27th ed 1994) at 1102.

3 Belgium, West Germany, the United Kingdom, Gambia, Israel, Italy, the Netherlands, and San Marino are those countries which have ratified the first Convention and the same countries excluding Israel have adhered to the second Convention. Winship, "The Scope of the Vienna Convention on International Sales Contracts" in Galston & Smit (ed), *International Sales* (Matthew Bender, New York, 1984) at 1-13; Berman & Kaufman, "The Law of International Commercial Transactions (Lex Mercatoria)" (1978) 19 *Harvard International L J* 221 at 265. Since these two Conventions mostly reveal the European Civil Law notion of the Contract, it has never been adopted in the US and their application in the UK was conditional on the parties' agreement. Cook, "The Need for Uniform Interpretation of the 1980 United Nations Convention on Contracts for the International Sale of Goods" (1988) 50 *University of Pittsburgh L R* 197 at 201.

4 These countries are Argentina, Australia, Austria, Belarus, Belgium, Bosnia and Herzegovina, Bulgaria, Canada, Chile, China, Cuba, the Czech Republic, Denmark, Ecuador, Egypt, Estonia, Finland, France, Georgia, Germany, Guinea, Hungary, Iraq, Italy, Lesotho, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, the Republic of Moldova, Romania, the Russian Federation, Singapore, Slovakia, Slovenia, Spain, Sweden, Switzerland, the Syrian Arab Republic, Uganda, Ukraine, the United States of America, Uzbekistan, Yugoslavia, and Zambia.

has been incorporated into the law of every State and Territory through separate but similar Acts and went into effect on 1 April 1989.[5] Section 5 of these Acts provides that the provisions of the Convention have the effect of law in the relevant State or Territory. Section 6 states that the provisions of the Convention prevail over any other law in force in the given State or Territory to the extent of any inconsistency. By virtue of the Federal legislation, s66a has been inserted into the *Trade Practices Act* 1974 (Cth) which provides: "The provisions of the United Nations Convention on Contracts for the International Sale of Goods, adopted at Vienna, Austria, on 10 April 1980, prevail over the provisions of this Division to the extent of any inconsistency".[6]

1.1. Application

Article 1 of the Convention clearly confines its applicability to contracts for the sale of goods between those parties whose places of business are in different Contracting States or when the rules of private international law lead to the application of the law of a Contracting State.[7] If an Australian trader, for example, enters into a sale contract with a Chinese partner, the Convention will apply to the contract because their places of business are within two Contracting States. If one or both of the parties have their places of business

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5 (ACT) Sale of goods (Vienna Convention) Act 1987
(NT) Sale of goods (Vienna Convention) Act 1987
(NSW) Sale of goods (Vienna Convention) Act 1986
(QLD) Sale of goods (Vienna Convention) Act 1986
(SA) Sale of goods (Vienna Convention) Act 1986
(TAS) Sale of goods (Vienna Convention) Act 1987
(VIC) Sale of goods (Vienna Convention) Act 1987
(WA) Sale of goods (Vienna Convention) Act 1986

6 Section 66a has been inserted by Act No 141 of 1987. For a discussion about the experience of federal countries in adopting international uniform rules see Brazil, "The Experience of Federal States" in UNIDROIT, *International Uniform Law in Practice* (Oceana Publications, New York, 1988) at 66-87.

7 A Contracting State is a country which has ratified, accepted or approved the Convention.

in States other than a Contracting State, the Convention will apply to their sales if conflict-of-law rules of the forum lead to the application of the law of a Contracting State. For example, if an Iranian trading party enters into a sale contract with an Australian partner, the Convention will not apply unless, in accordance with conflict-of-law rules of the forum, the governing law of the contract is the law of Australia or another Contracting State.[8]

By virtue of Article 95 of the Convention at the time of the deposit of the instrument of ratification or accession, a State may make a reservation to limit the applicability of the Convention only to cases where both parties' places of business are within Contracting States.[9] As a result, if two parties' places of business are not within the Contracting States and a dispute brought before the courts in a State made such a reservation, the governing law with the exception of the Convention will apply to their sale contract.[10] For instance, if with respect to the above sale contract between Iranian and Australian parties a dispute is brought before a court in the US, the court implements its own conflict-of-law rules to determine the applicable law. If Australian law or US law is determined as the applicable law, the court will apply the US or Australian law excluding the Convention, because the US has made such reservation.

The application of the Convention to international sales contracts does not need the agreement of the parties if their places of business are within the Contracting States or if according to private international law, the law of a Contracting State is the applicable law of the contract. However, the parties may exclude its application or derogate from or vary

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8 Nicholas, "The Vienna Convention on International Sales Law" (1989) 105 *Law Q Rev* 201 at 205.

9 Article 95 of the Convention reads: "Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will not be bound by subparagraph (1)(b) of article 1 of this Convention."

10 China, the US, the Czech Republic, Slovakia, and Singapore have made that reservation under Article 95.

the effect of any of its provisions.[11] As a result, the Convention automatically applies to sales of goods unless otherwise agreed by the parties.[12] Although an explicit term as to the derogation is not necessary,[13] the parties' intention in this regard needs to be determined.[14] Since the Convention allows parties to derogate or to vary the effect of its provisions, it provides flexibility to parties to exclude or vary the effect of certain provisions which may be inappropriate for their particular needs.

By virtue of Articles 1, 2 and 3, certain contracts are excluded from the automatic coverage of the Convention. In cases where the contract falls outside the automatic scope of the Convention, the parties may wish to select the Convention to govern their deal. Although there is no reference in the Convention permitting the parties to do so, such a choice will be upheld in most jurisdictions under the principle of parties' autonomy in choosing the proper law or incorporating desirable provisions into the contract.[15] As a result, if a form of

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11 Article 6 of the Convention.

12 At the 1977 meeting, the Australian delegation which was concerned about the applicability of the Convention pointed out:

> Careful consideration needs to be given to the question whether the application of the convention to an international sale of goods should be automatic, except to the extent that the parties to the international sale otherwise provide or whether it should apply only when the parties agree that it apply. States which view the Convention quite favourably as a whole may nevertheless have reservations concerning particular issues, having regard to their existing commercial practices. They could be reluctant to accede to the convention if its application is automatic.

UNCITRAL, *Yearbook* vol VIII (UN, New York, 1977) at 110.

13 It is to be noted, however, that the Convention does not explicitly provide that such exclusion may also be implied. By comparison, the *Uniform Law on the International Sale of Goods* (Hague 1964) provides clearly that exclusion could be implied; its Article 3 reads: "The parties to a contract of sale shall be free to exclude the application thereto of the present Law either entirely or partially. Such exclusion may be *express or implied*." [emphasis added]

14 Commentators have given different views as to the possibility of an implied exclusion. Some supports the idea that any exclusion must be explicit. Klepper, "The Convention for the International Sale of Goods" (1991) 15 *Maryland J International L & Trade* 235 at 238; Nicholas, "The Vienna Convention on International Sales Law" (1989) 105 *Law Q Rev* 201 at 208; Feltham, "The United Nations Convention on Contracts for the International Sale of Goods" (1981) *J Business L* 346 at 348. Others point out that the exclusion can be made either expressly or implicitly; see Sacks, "International Sale of Goods and Services" in Sacks & Malbon (ed), *Australian Export Manual* (Longman Professional, Melbourne, 1992) at 21.

15 Article 4 of the Preliminary Draft Convention (1976) stated: "This Convention also applies where it has been chosen as the law of the contract by the parties". A/CN 9/116 (March 1976) Annex I; UNCITRAL, *Yearbook* vol VII (UN, New York, 1976) at 89. Although this article was deleted in

countertrade has fallen outside the scope of the Convention, the parties may apply it to that particular form of countertrade to benefit from its advantages.

1.2. The Convention and the Applicable Law

The application of the Convention to international sales contracts does not terminate the need for a governing law. Although it has been designed to provide a uniform substantive law, there are still some issues which need to be settled by reference to the governing law of the contract. The validity of a contract or its provisions, for example is one of these issues.[16] Those matters which are not expressly settled in the Convention are also to be settled by the law determined by virtue of conflict-of-law rules.[17] The Convention, for instance, is silent about the capacity of the parties and liability for commercial fraud which "are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of

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the final version, the deletion by no means indicates the impossibility of choosing the Convention as the law of a transaction exempted from its automatic application. If that article had not been deleted, the Contracting States would be required to apply the Convention even if such choice was against either mandatory rules or public policy. The inclusion of that article would have permitted the parties whose places of business within one Contracting State to choose the Convention. Because that article has been deleted, the choice of the Convention as the law for the exempted transactions will be disregarded by the forum if such choice is against mandatory rules or public policy of the forum. For example, while by virtue of Article 2(e) the sale of aircraft is excluded from the scope of the Convention, the parties may agree to subject the sale to the Convention. That choice will be disregarded if it violates mandatory rules of the forum or if it is against public policy. For a discussion about aircraft and the Convention see Winship, "Aircraft and International Sales Conventions" (1985) *J Air L & Commerce* 1053.

16 Article 4 of the Convention reads:

> This Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this Convention, it is not concerned with:
> (a) the validity of the contract or of any of its provisions or of any usage;
> (b) the effect which the contract may have on the property in the goods sold.

17 Article 7(2) of the Convention provides:

> Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

private international law".[18] For example, when a case was brought before the German Court of Appeals, the amount of recoverable interest was determined by reference to the governing law of the contract because although the possibility of a claim for an interest is prescribed in Article 78 of the Convention, it gives no guidance as to its calculation.[19]

1.3. The Significance of the Convention for Countertraders

There are some reasons underlying the necessity of considering the Convention when countertrade contracts are to be drafted. As mentioned above, the application of the Convention is automatic and there is no need to agree on it. In *Filanto v Chilewich International Corp*,[20] for example, the plaintiff was barred from initiating a suit against Chilewich in the US Federal District Court of New York because the parties were not aware that their transaction was subject to the Convention.[21] Another example is a sales contract between a German retailer and an Italian clothing manufacturer where the buyer refused payment on the basis that it notified the seller of "poor workmanship and improper fitting" of the goods within eight days after delivery. The German court, who applied the Conventions to the contract, held that according to Article 39 of the Convention the buyer lost the right to rely on non-conformity because of a failure to specify precisely the defect in the goods.[22] These two cases show that it is important for the parties to be aware whether or not the Convention applies to their contract.

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18 Article 7 of the Convention.

19 Oberlandesgericht Frankfurt AM Main; 5u 261/190 (13 June 1991). See Diederichsen, "Commentary to *Journal of Law & Commerce* Case I; Oberlandesgericht, Frankfurt Am Main" (1995) 14 *J of Law and Commerce* 177 at 180.

20 789 F Supp 1229 (1992).

21 Del Duca, "Practice Under the Convention on International Sale of Goods: A Primer for Attorneys and International Traders (Part I)" (1995) 27 *Uniform Commercial Code Law J* 331 at 336.

22 A summary of the case in English is available in CLOUT (Case Law on UNCITRAL Texts) Case 3: CISG 1(1)(b): 39.

To draft a countertrade contract, it is important to analyse the provisions of the Convention in the light of the governing law and the principle of parties' autonomy. On the one hand under Article 4, the validity of the sales contract is determined by the governing law and under Article 7(2) the governing law has a gap-filling function for those issues not settled in the Convention. On the other hand, Article 6 gives the parties an unqualified right to vary the effect of its provisions by agreement. As a result, in drafting a countertrade contract it is also necessary to take into account the relevant rules of the applicable law to ascertain their impacts on countertrade contracts. The parties may need to compare the Convention to the applicable law to consider whether the Convention provides additional advantages for the parties. For example, the German court held that the supply of goods of inferior quality did not constitute a fundamental breach for the purposes of the Convention justifying the avoidance of the contract and refusal of payment.[23] The applicable law may provide greater support to the buyer who has received poor quality goods.

Although the Convention has been designed to provide a uniform substantive law for the sale contract, there is still a concern that it will suffer from diverse interpretations in different jurisdictions.[24] This concern is aggravated in cases about which the Convention is

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23 CLOUT (Case Law on UNCITRAL Texts) Case 83: CISG 35; 45(1)(c).

24 In this regard, the Convention itself provides in Article 7(1) guidelines as to the issue of interpretation. This Article states:

> In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

It has been emphasised by some scholars that bringing uniformity and certainty to the international trade regime "is based on an international interpretation which is free from any domestic ties so that the international trader can rely on it without having to be concerned with parochial biases and idiosyncrasies stemming from the trading partner's domestic legal system". Koneru, "The International Interpretation of the UN Convention on Contracts for the International Sale of Goods: An Approach Based on General Principles" (1997) 6 *Minnesota Journal of Global Trade* 105 at 151. Some other scholars, however, remarked that Article 7 is only a guideline for judges rather than a narrow way of interpretation. Pryles, "An Assessment of the Vienna Sales Convention" (1989) *Australian Mining & Petroleum L Association Yearbook* 337 at 347.

silent or vague. These interpretations might be different or even contradictory from court to court. Whenever the parties think that an issue may be interpreted in a different way, it is in their interest to make it clear through inserting appropriate provisions or explanatory terms into the contract.

2. Barter and the Convention

Since there is no express reference to barter within the Convention, it is not clear whether the Convention covers barter deals. Article 1 of the Convention confines its scope to contracts for the international sale of goods. By virtue of Article 2 of the Convention, six categories of sales have been excluded from its coverage. Barter is not one. Since the applicability of the Convention to barter contracts depends on ascertaining that a barter deal is a sales contract within the meaning of the Convention, the first issue to be discussed is whether or not sale includes barter.

2.1. Does Sale of Goods include Barter?

A contract for the sale of goods can be defined as an arrangement by which the seller transfers or agrees to transfer the property in goods to the buyer for a consideration called the price.[25] If it is required that the price be in money, a sales contract can easily be distinguished from a barter because in barter one party transfers goods in return for some other goods instead of money. In some jurisdictions, sale of goods is defined by statute in

25 "In its broad sense a sale has been defined as the transfer of the property in a thing for a price in money or estimated in money, or in money or its equivalent, or for a valuable consideration." 77 *Corpus Juris Secundum* at 576.

such a way that it excludes barter contracts. For instance, under the *Sale of Goods Act* 1979 of England if a contract provides for the exchange of goods for goods or services, the contract does not constitute a contract for the sale of goods. Its Article 2(1) provides: "A contract of sale of goods is a contract by which the seller transfers or agrees to transfer the property in goods to the buyer for a money consideration, called the price".[26] Following the UK *Sale of Goods Act* 1893, the *Sale of Goods Acts*,[27] which are in force in various States and Territories of Australia, also exclude barter from the coverage of the Acts.[28] Section 6(1) of the *Sale of Goods Act* 1923 (NSW), for example, provides: "A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a *money* consideration called the price".[29] For the purposes of these Acts, a barter contract is not a contract of sale and consequently barter is outside the scope of these statues. In some other jurisdictions, sale of goods is defined in such a way that it also applies to barter contracts. For example, Article 2-304(1) of the US *Uniform Commercial Code* (UCC) reads: "The price can be made payable in money or otherwise. If it is payable in whole or in part in goods each party is a seller of the goods which he is to transfer". As a

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26 It should be noted that a contract of barter is also a sales contract within the scope of the *Supply of Goods and Services Act* 1982 of the UK. In *Simpson v Connolly* [1953] 1 WLR 911 at 915, it was mentioned that "a sale or a contract of sale is an agreement to exchange goods for money, although it is possible that part of the consideration might be something other than money, as, for example, when a person buys a new car for an agreed price, part of which he pays in money and part of which he satisfies by means of surrounding another car. But the general principle of English law is regard to sale is that a sale means the exchanging of property for money."

27 Sale of Goods Act 1923 (NSW)
Sale of Goods Act 1954 (ACT)
Sale of Goods Act 1927 (NT)
Sale of Goods Act 1896 (Qld)
Sale of Goods Act 1895 (SA)
Sale of Goods Act 1896 (Tas)
Goods Act 1958 (VIC)
Sale of Goods Act 1895 (WA).

28 Based on the *Sale of Goods Act* 1893 (UK), these Acts in Australia are almost identical to each other. It should be noted that the *Sale of Goods Act* 1983 (UK) has been replaced by the *Sale of Goods Act* 1979 (UK) Sutton, *Sales and Consumer Law* (LBC Information Services, Sydney, 4th ed 1995) at 5.

29 Section 6(1) of the *Sale of Goods Act* 1923 (NSW) [Emphasis added].

result, there is no consensus between different jurisdictions as to whether or not sale includes barter. It is therefore necessary to examine the provisions of the Convention to see whether it covers barter or not.

2.2. Applicability of the Convention to Barter

Although the Convention applies only to contracts for the sale of goods, it provides no definition of what a sales contract is. On the other hand, it does not require that the price must be paid in money. Article 53 provides: "The buyer must pay the price for the goods and take delivery of them as required by the contract and this Convention". This Article and other related Articles, such as Articles 54 to 59, which deal with the price, can be read in such a way to cover payment in either money or goods. As a result, the Convention is apparently applicable even if the price is in kind.

It can be argued that although the Convention does not define *sales contracts*, its provisions as a whole indicate that the Convention only concerns the exchange of goods against money. In this regard, Professor Pryles said:

> Article 30 defines the obligation of the seller as one to deliver the goods, hand over any documents relating to them and transfer property in the goods. On the other hand, the obligation of the buyer is stated in Article 53 to be the payment of the price for the goods and the taking delivery of them. Detailed provisions are contained in the Convention as to the time and place for the payment of the price. Thus, the overall impression is that the Convention is only concerned with contracts whereby goods are exchanged for money.[30]

In support of this argument, it can be added that the use of 'pay' in Article 53 implies the presumption of a money price, because 'pay' has frequently been used in respect of money

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30 Pryles, "An Assessment of the Vienna Sales Convention" (1989) *Australian Mining & Petroleum L Association Yearbook* 337 at 346.

while 'delivery' has been used with reference to goods. In this regard, Maskow wrote: "The obligation of the buyer to pay the price implies that a monetary performance is required. The impression that the price involves payment in money is strengthened by certain provisions concerning payment".[31]

In reply to the above argument, it could be said that the adoption of such language by the Convention, which predominantly relates to those sales contracts by which goods are exchanged for money, is for the sake of simplicity and to prevent multiplicity of indications. For example, even though the Uniform Commercial Code (UCC) explicitly provides that the price might be in goods[32] its language is very similar to that of the Convention as if the price is only money. Concerning UCC Articles 2-301, 2-307 and 2-310, the use of expressions such as *the seller is to deliver and the buyer is to accept and pay*, *the buyer is to receive the goods*, *the buyer may inspect the goods* and *the seller is required to ship the goods* is only to avoid a complex and confusing language caused by using goods and payment for both the buyer and seller.[33] As a result, the use of such expressions throughout the

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31 Bianca & Bonell (ed), *Commentary on the International Sales Law* (Giuffre, Milan, 1987) at 386.

32 UCC Article 2-304.

33 UCC Article 2-301 provides:

> The obligation of the *seller* is to transfer and *deliver* and that of the *buyer* is to accept and *pay* in accordance with the contract. [emphasis supplied]

UCC Article 2-307 says:

> Unless otherwise agreed all *goods* called for by a contract for sale must be tendered in a single *delivery* and payment is due only on such tender but where the circumstances give either party the right to make or demand delivery in lots the price if it can be apportioned may be demanded for each lot. [emphasis supplied]

UCC Article 2-310 states:

> Unless otherwise agreed
> (a) payment is due at the time and place at which the *buyer* is to *receive the goods* even though the place of shipment is the place of delivery; and
> (b) if the seller is authorised to send the goods he may ship them under reservation, and may tender the documents of title, but the *buyer* may *inspect the goods* after their arrival before payment is due unless such inspection is inconsistent with the terms of the contract (Section 2-513); and
> (c) if delivery is authorised and made by way of documents of title otherwise than by subsection (b) then payment is due at the time and place at which the *buyer is to receive the documents regardless of where the goods are to be received*; and

Convention does not necessarily indicate that it is only applicable to those sales contracts whereby goods are transferred against money. For the purposes of simplicity, the language used in such legal documents focuses on normal and frequent cases of goods for money instead of rare cases of goods for goods.

2.3. Discussion and Conclusion

In sum, there are two different opinions about the applicability of the Convention to barter contracts. On one hand, it is argued that the Convention does not apply to barter deals because barter is not a sales contract in a real sense.[34] One the other hand, it is argued that barter is a kind of sale of goods and consequently is covered by the Convention.[35] In plain meanings, *sale* is not literally synonymous with *barter* and each has its own particular meaning.[36] Under a sales contract certain goods are transferred to the buyer against the price, irrespective of whether or not the price has to be made in money, while under a contract of barter two items are simply exchanged for each other without any intention to deal with one item as the price of the other. Thus, although the Convention does not require that the price must be in money, the concept of *sale* implies that the mere exchange of goods for goods is not a sale. In other words, when some goods are transferred in exchange for some others, the contract is a sales contract if the contracting parties deal with the goods in one direction as the price for the other. A similar conclusion could be reached

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> (d) where the *seller* is required or authorised *to ship the goods* on credit the credit period runs from the time of shipment but post-dating the invoice or delaying its dispatch will correspondingly delay the starting of the credit period. [emphasis supplied]

34 Von Caemmerer/ Schlechtriem, *Kommentar Zum Einheitlichen UN-Kaufrecht* (C.H. Beck'sche Verlagsbuchhandlung, Munchen, 1995) at 50.

35 Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 102ff.

36 9 *Corpus Juris Secundum* at 1551.

in respect of the UCC. Since under Article 2-106(1) of the UCC a sale consists in the passing of title from the seller to the buyer for a price, "a sale of goods is an agreement whereby the seller transfers the property in the goods to the buyer for a consideration called price".[37] Under Article 2-304, the price can be made payable in money or otherwise. Although Article 2-106(1) says that a sales transaction is exchange of goods for a price, Article 2-304 provides that money is not the sole mode of payment. Consequently, a sales contract by which goods are exchanged for a price is distinct from a barter contract by which each party gives up something to gain the other party's goods, irrespective of variations in quality, quantity and value.[38]

As a result, the application of the Convention to cases where goods are exchanged for some other goods depends upon determining the concept of *transferring property for a price.* The contract may explicitly provide that the goods in one direction are the price for the contract or that it is a *sales* contract. In cases where no explicit indication is inserted into the contract, a sales contract may be ascertained on account of circumstances surrounding the contract. For example, if goods in one direction are evaluated in money, it is an indication that the contract is apparently a sales one.[39] Similarly if it is possible to perform the contract through either delivery of goods or payment of money or if money is partially involved,[40] the contract is a sales one.[41]

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37 *Schneider v Noel* 160 P 2d 1002 (1945) at 1007.

38 In *Jenkins v Mapes* 41 NE 137 (1895) at 137, the Supreme Court of Ohio said:

> A barter is a transaction where goods are exchanged for goods. And it is immaterial whether the goods exchanged are of the same kind and quality, or of an entirely different species, or whether mutual delivery is had contemporaneously with the making of the contract, or delivery by one is made then, and delivery by the other is to occur afterwards.

See also Squillante & Fonseca (ed), *Williston on Sales*, (CBC, New York, 5th ed 1992) at 32.

39 In *Fain Land v Hassell* 790 P 2d 242 (1990) at 247, the Supreme Court of Arizona said: [T]he test for determining whether a transaction constitutes a sale or an exchange is whether there is a fixed value at which the exchange is to be made - it is considered a sale if there is a fixed value and an exchange if there is not. *Hawn v Malone* 188 Iowa 439, 176 NW 393, 395 (1920).

40 In *Sheldon v Cox* (1824) 3 B & C 420, *A* agreed to give a horse, warranted sound, in exchange for a horse of *B* and a sum of money. The court said: "The plaintiff delivered a horse to the defendant

In sum, it can be concluded that barter, in comparison with sale, is confined to cases where each party gives up something to gain the other party's goods without intending to achieve a balance between their values. Such an intention is rare in international trade where barter is used to enable the buyer to pay for the goods where it otherwise cannot afford to buy. As Doull J said in *Messenger v Greene*, in the commercial context all barter contracts are a kind of sale in which consideration is made payable in goods.[42] Unless a particular statute requires that consideration must be made in money,[43] sale includes cases where payment is made in goods if it can be characterised as a transaction involving a price equivalence. Since the Convention does not require that the price must be made in money, the price can also be made in kind. As a result, an international barter contract can be a sales contract within the meaning of the Convention because one party suffering from hard currency shortage pays goods for the products purchased. However, since different jurisdictions may deal with barter in different ways, it is preferable if parties expressly state whether or not the Convention should apply to their barter contract.

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to be paid for partly by a horse of the defendant, and partly by money. The defendant delivered his horse but refused to pay the money. It is difficult to suggest any reason why that sum may not be recovered in a common count as part of the price of a horse, *sold* and delivered by the plaintiff to the defendant." [emphasis supplied] At 421, per Curiam.

41 In *Griswold v Tucker* 216 SW 2d 276 (1948) at 278, the Court of Civil Appeals of Texas pointed out:

> There is a recognised difference between an exchange and a sale. The test seems to be if one party passes his property to another and in turn receives from the latter his property without having an agreed value placed on both, it is deemed an exchange. Upon the other hand, a transaction is a sale although made for something other than money, where the property of each is transferred at an agreed or market value. This is likewise true if the property of one is transferred to another at an agreed price in part payment or the agreed total cash value of the other.

42 In *Messenger v Greene* [1937] 2 DLR 26 at 28, Doull J said:

> It is quite true that a trader might agree with a woodsman that he would give him a half chest of tea for five cords of pulpwood and such a contract would be one of barter and different considerations would govern it. But such a method of trading is now very unusual.

43 As mentioned above the *Sale of Goods Acts* of different States and Territories in Australia require a money consideration.

3. Counterpurchase and the Convention

A counterpurchase package consists of a number of contracts regulating rights and obligations of parties in respect of exports and counter-exports. The application of the Convention to these contracts largely depends on their formats. In a typical counterpurchase package, there are three contracts: i) an export contract under which the initial exporter sells certain products to the importer; ii) a protocol under which the initial exporter undertakes to counter-purchase certain products from the importer; and iii) a counter-purchase contract under which the initial exporter implements its obligations of counter-exporting. The application of the Convention to these three contracts will be discussed below.

3.1. The Export Contract and the Convention

The export contract is a typical sales contract under which an exporter sells certain goods to an importing party. Although the exporter is required to counter-purchase some products in return, the export contract generally has no reference to that obligation. The Convention definitely covers this export contract as with other sales contracts. In cases where the export contract has a provision linking it to the counter-purchase contract, such a linkage is not a factor pushing the contract out of the coverage of the Convention, although it is an additional obligation upon the exporter which demands an extra performance.[44] There are no provisions within the Convention prohibiting the parties taking extra obligations in a

44 Bianca & Bonell (ed), *Commentary on the International Sales Law* (Giuffre, Milan, 1987) at 386.

sales contract. On the other hand, since Article 6 permits them to tailor its provisions to their needs, they may add an extra obligation to counter-purchase.

3.2. The Protocol and the Convention

The reciprocity of a counterpurchase arrangement is generally set out in a protocol as a framework to link the export to the counter-export. Under a typical protocol, the initial exporter undertakes to counter-purchase some products in return for its own exports. The application of the Convention to such a framework agreement mainly depends on obligations set forth there and its precise terms. This protocol may be drafted in the form of a letter of intent by which the parties declare their intention to enter into a number of mutual export and counter-export contracts.[45] The protocol may set out the parties' obligations more generally by requiring a trading party (mostly the initial exporter) to counter-purchase some products without identifying the kind of goods, quality, price or even the persons from whom the counter-purchase is to be accomplished.[46] Although such protocols, as framework agreements, are contracts, the Convention does not apply to them, because the Convention is only applicable to sales contracts.[47] In accordance with Article 14 a proposal to conclude a sale constitutes an offer if it is *sufficiently definite*. "A proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for

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45 In a sample counterpurchase agreement drawn up by the Malaysian Ministry of Trade and Industry, the following term has been inserted: "That either side shall purchase goods and commodities for a total value of ...". Rubin, *The Business Manager's: Guide to Barter, Offset and Countertrade* (The Economist Intelligence Unit, London, 1986) at 98.

46 In a countertrade agreement with East Germany, the Western company, as the initial exporter, committed itself to buy or have bought by third parties of its free choice, goods suitable to it at competitive prices and terms of delivery as herein defined by the company. Rubin, *The Business Manager's: Guide to Barter, Offset and Countertrade* (The Economist Intelligence Unit, London, 1986) at 75.

47 To be an enforceable contract, a letter of intent needs to be adequately definite or ascertainable. In cases where the letter of intent is too broad and ambiguous, its legal implications may differ from jurisdiction to jurisdiction. For more details see Chapter 7, pages 280-297.

determining the quantity and price."[48] Because in protocols the parties make a framework agreement for subsequent definite contracts to be entered into, they are not subject to the Convention which deals only with sale of goods contracts.

However, the protocol may be drafted precisely enough to satisfy the requirements set forth in the Convention. To be sufficiently definite, the protocol must be specific in respect of the type of goods to be exported or counter-exported. In addition, the quantity and price of the goods must be definite or some mechanism for their determination is inserted into the protocol.[49] However, the form, measurement or other features of the goods can be left to the buyer to be determined later.[50] If the protocol specifies the goods to be exported or counter-purchased and either fixes the quantity and price or provides a mechanism for their determination, a *contract to sell* occurs because the sale is to be made subsequently.[51] While under a contract of sale the property in the goods is transferred from the buyer to the seller, a contract to sell is a contract whereby the seller agrees to transfer the property in goods to the buyer for a price at a future time.[52] In *Bailey v Balholm Securities*, Kerr J said: " 'Futures' are contracts for the sale or purchase of commodities for future delivery on a date and at a price fixed at the date of the contract."[53]

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48 Article 14(1) of the Convention.

49 Article 14(1) of the Convention.

50 Article 56 of the Convention.

51 Alternative expressions are: 'agreement to sell', 'executory contract of sale' and 'executory sale'. *Benjamin's Sale of Goods* (Sweet & Maxwell, London, 3rd ed 1987) at 23.
It is said in *Chitty on Contracts* that "a sale of goods is both a contract and a conveyance; an agreement to sell, on the other hand, is a contract and nothing more". *Chitty on Contracts,* vol 2 (Sweet & Maxwell, London, 27th ed 1994) para 41-008.

52 Similar to section 2 of the *Sale of Goods Act* 1979 (UK), Article 6(3) of the *Sale of Goods Act* 1923 (NSW) provides: "Where under a contract of sale the property in the goods is transferred from the seller to the buyer, the contract is called a sale; but where the transfer of the property in the goods is to take place at a future time, or subject to some condition thereafter to be fulfilled, the contract is called an agreement to sell." In the US context, it has been also said that a "contract to sell goods, as distinguished from a sale contract, is a contract whereby the seller agrees to transfer the property in goods to the buyer for a price which the buyer pays or agrees to pay, as where there is no price paid for the goods and no delivery of them". 77 *Corpus Juris Secundum* at 577-78.

53 [1973] 2 Lloyd's Rep 404 at 405.

The Convention does not explicitly address the coverage of future sales. Under Article 3, however, contracts for the supply of goods to be manufactured or produced are generally considered to be sales contracts for the purposes of the Convention, although they are a kind of 'contract to sell'. There is no peculiarity in these supply contracts to limit the scope of the Convention only to them and exclude other future sales from its coverage.[54] However, there is no consensus between the commentators as to the applicability of the Convention to every 'contract to sell'.[55] Some believe that the Convention "does not apply to contracts for the sale of future goods not to be manufactured by the seller".[56] Nevertheless, since the overall impression is that the Convention applies to contracts to sell so far as they are sufficiently definite, it applies to a protocol or a framework agreement whereby an exporter undertakes to purchase specific goods with a fixed or determinable quantity and price at some time in the future.

3.3. The Counter-Purchase Contract and the Convention

The counter-purchase contract is a definite sales contract under which the initial exporter purchases some products to implement its counter-purchase obligation. This contract may be entered into as required by the protocol or by the first export contract. In either case, the contract is a sales contract and falls within the scope of the Convention. The only difference between the counter-purchase contract and a typical sales contract is that the

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54 Skelton, "Potential Effects of the International Sales Convention on US Crude Oil Traders" (1986) 9 *Houston Journal of International Law* 95 at 97.

55 Fisher & Hains, "Futures Market Law and Practice and the Vienna Sales Convention" (1993) *Lloyd's Maritime and Commercial Law Quarterly* 531 at 539; UNCITRAL, *Yearbook* vol VIII (UN, New York, 1977) at 166.

56 Maurer, "The United Nations Convention on Contracts for the International Sale of Goods" (1989) 15 *Syracuse J International L & Commerce* 361 at 366.

former is concluded pursuant to a previous obligation set forth in a protocol or in the first export contract. Since there is no provision in the Convention limiting its scope to those sales contracts which are not required by another agreement, it also applies to those sales contracts which are entered into as implementing a previous obligation.

3.4. A Hypothetical Example and Conclusion

The following hypothetical example is helpful in providing a better understanding of the applicability of the Convention on different contracts in a counterpurchase package. Suppose an Australian wool producer negotiated a counterpurchase arrangement with a trading partner in China to export wool to China and in return to counter-purchase some of China's products. Negotiations have resulted in the following two agreements: i) a sales contract under which the Australian party sells one thousand tonnes of wool to China at a specific price; and ii) a protocol under which the Australian party undertakes to counter-purchase China's products up to the value of 80% of the first contract's worth. Subsequently the Australian party purchases some products from China as required in the protocol. The Convention definitely applies to the first contract, irrespective of whether the wool has already been produced or is to be produced.[57] Nevertheless, the protocol is not governed by the Convention because it is not sufficiently definite. In addition to uncertainty in persons from whom the purchase has to be made, this protocol is vague in respect of goods to be counter-purchased, their price and the quantity. The Convention would also cover the protocol if it was drafted more precisely in terms of the goods, the price and the

57 Article 3 of the Convention.

quantity. The subsequent counter-purchase of China's products by the Australian party would also be a sales contract within the meaning of the Convention.

In conclusion, the application of the Convention to various contracts in a counterpurchase package depends on their contents and their precise terms. If a sales contract is ascertained, the Convention applies to it even if the contract is part of a package. A protocol or a framework agreement containing a commitment to conclude a sales contract in the future is subject to the Convention if it is sufficiently definite in respect of the goods, quantity and the price.

4. Buy-backs & Offsets and the Convention

Buy-back or offset packages generally contain a number of agreements to transfer property, provide services, grant licences, participate in co-production, purchase back the output or undertake some counter-obligations in order to transfer know-how, technology and skills or to invest. The Convention applies to contracts for the sale of goods even if they are part of an offset or buy-back package so far as they constitute a separate sales contract. It is also clear that the sale of services and agreements to invest are outside the coverage of the Convention. In practice, however, buy-back or offset programs involve sales contracts which are a combination of transferring tangible or intangible property and providing services. For example, the contract might be one for the sale of goods to be manufactured; sale of machinery and equipment to be erected; sale of technology, know-how and licences; and an undertaking to purchase back the outputs. To see whether the Convention covers these types of contracts, they are divided here into three main categories. In the first, sales contracts which involve both goods and services will be examined; the second will deal with those cases where intangible property such as know-how, licences or technology is to be transferred; and the third will focus on agency and distributorship agreements.

4.1. Contracts Involving the Transfer of Both Goods and Services

In buy-back or offset programs the sale of certain goods is often accompanied by some type of service. Service contracts to carry out a piece of work may also involve transfer of some goods. For example, when a Western exporting party agrees under a buy-back arrangement to sell certain machinery and equipment to be installed in a developing country, a hybrid contract of the sale of goods and services occurs. Similarly, when a party undertakes to co-operate with a developing country in exploiting a mine and agrees to sell the machinery and equipment needed for the project, the service contract involves transfer of goods. The application of the Convention to these contracts depends on whether they are categorised as one for the sale of goods or sale of services. It is therefore necessary to establish certain criteria according to which a mixed contract should be categorised as one for the sale of goods or for services. Prior to discussing these criteria from the standpoint of the Convention, it might be useful to consider the experience of Anglo-Australian and US legal systems in categorising these mixed contracts either as one for the sale of goods or services.

4.1.1. The Experience of Anglo-Australian and US Law

The distinction between sales contracts and service contracts has been significant in the Anglo-Australian legal system because the application of the *Sale of Goods Acts* has been limited to the sale of goods.[58] Such a distinction was very relevant because *implied warranties as to fitness for purpose* were implied by statute exclusively to the sale of goods. Today, however, implied warranties are also presumed in service contracts by analogy.[59] Although to a great extent the significance of distinguishing the two has been reduced in England and Australia,[60] there are still some places where such a distinction needs to be made.[61]

In the US the issue of distinction between a sale of goods and a service contract is still of importance. Section 2-102 of the *Uniform Commercial Code* (UCC) provides: "Unless the context otherwise requires, this Article [Article 2] applies to transactions in goods".[62] Section 2-105 defines the goods as "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action". As a

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58 These Acts are the *Sale of Goods Act* (1979) of England, which has replaced the *Sale of Goods Act* (1893), and *Sale of Goods Acts* in force in different States and Territories in Australia. See above note 27.

59 *Benjamin's Sale of Goods* (Sweet & Maxwell, London, 3rd ed 1987) at 30.

60 One of the main reasons underlying the necessity of distinguishing between a contract for sale of goods and one for services was the exclusive application of the implied warranties or conditions of sales contracts. This notion, however, is no longer of importance in England and Australia. In England the *Supply of Goods and Services Act* (1982) applies these implied terms equally to both sale and service contracts. *Chitty on Contracts,* vol 2 (Sweet & Maxwell, London, 27th ed 1994) para 41-014. In Australia s74 of the *Trade Practices Act* 1974 (Cth) implies such warranties to a service contract and the parties cannot avoid them by agreement.

61 The distinction is important in Western Australia, Tasmania and the Northern Territory where a requirement of form is still needed for those sales of goods of the value of $20 or more in the first two States and of the value of $50 or more for the Northern Territory. Drawing the distinction is also needed for purposes of other legislation applying to sale of goods such as *Door to Door Sale Acts*, 1963 (Vic). See Sutton, *Sales and Consumer Law* (LBC Information Services, Sydney, 4th ed 1995) at 80-81.

62 In *Uniform Commercial Code Revised Article 2: Sales*, the following section has been proposed to replace s2-102a:

> Unless the context otherwise requires, this Article applies to:
> (1) any transaction, regardless of form, that creates a contract for the sale of goods, including a transaction in which a sale of goods predominates;
> (2) any dispute relating to goods supplied under a transaction in which the sale of goods does not predominate; and
> (3) any dispute arising under an agreement obligating the seller to install, customise, service, repair, or replace goods at or after the time of contracting.

result, Article 2 of the UCC, known as *Sales*, applies only to sale of goods and obviously a contract to perform a service is outside its coverage.[63] Traditionally, the *warranty standards* have been considered inappropriate in service contracts because these contracts involve no transfer of physical assets. As a result, the implied warranty mentioned in section 2-105 of the UCC is relevant only to those goods transferred through sale of goods.[64] Moreover, the requirement of a written document set out in section 2-201 for contracts over $500 is exclusive to sale of goods.

To distinguish sales contracts from service contracts, certain criteria have been developed in these legal systems. Under one measure, a hybrid transaction is categorised as a sale or as a service contract depending on what the contract eventually results in. If carrying out the contract results in goods, the contract is a sale one. This test which has widely been adopted by English courts is well set forth in the words of Blackburn J in *Lee v Griffin*:

> If the contract be such that, when carried out, it would result in the sale of a chattel, the party cannot sue for work and labour; but if the result of the contract is that the party has done work and labour which ends in nothing that can become the subject of a sale, the party cannot sue for goods sold and delivered. The case of an attorney employed to prepare a deed is an illustration of this latter proposition. It cannot be said that the paper and ink he uses in the preparation of the deed are goods sold and delivered. The case of a printer printing a book would most probably fall within the same category. ... I do not think that the test to apply to these cases is whether the value of the work exceeds that of the materials used in its execution; for, if a sculptor were employed to execute a work of art, greatly as his skill and labour, supposing it to be of the highest description, might exceed the value of the marble on which he worked, the contract would, in my opinion, nevertheless be a contract for the sale of chattel.[65]

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63 Section 2-101 of the UCC provides: "This Article shall be known and may be cited as Uniform Commercial Code-Sales."

64 Section 2-315 of the UCC provides: "Where the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is unless excluded or modified under the next section an implied warranty that the goods shall be fit for such purpose."

65 (1861) 1 B & S 272 at 277-278.

This test, followed in Australia in *Lyons v Hughes*[66] more than a century ago, has been endorsed once again in *Deta Nominees v Viscount Plastic Products*.[67] Therefore, if the performance of the contract results in some goods, the contract is one for the sale of goods, irrespective of the value of the services used.

Under a second test, the element in distinguishing a contract for the sale of goods from one for services is the substance of the transaction. If its substance is transferring goods, the contract is one for the sale of goods; if its substance is providing works and labour, it is a service contract. In *Clay v Yates*, Pollock C B said "that the true criterion is, whether work is the essence of the contract, or whether it is the materials supplied".[68] In support of this test, in *Robinson v Graves*, Greer J said:

> If you find ... that the substance of the contract was the production of something to be sold by the dentist to the dentist's customer, then that is a sale of goods. But if the substance of the contract, on the other hand, is that skill and labour have to be exercised for the production of the article and that it is only ancillary to that that here will pass from the artist to his client or customer some materials in addition to the skill involved in the production of the portrait, that does not make any difference to the result, because the substance of the contract is the skill and experience of the artist in producing the picture.[69]

In addition to these two major tests, some other measures have also been provided by scholars. For example, the degree of independence exercised by the provider of services is a measure according to which a contract for the sale of goods may be distinguished from one for services because in service contracts there is generally more control over the worker than in a sale of goods even if the goods are to be manufactured.[70] Under another measure,

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66 [1875] 1 VLR (L) 1.
67 [1979] VR 167 at 183.
68 (1856) 1 H & N 73 at 78.
69 [1935] 1 KB 579 at 587.
70 Lorenz, "Contracts for Work on Goods and Building Contracts" in *International Encyclopaedia of Comparative Law* vol VIII(8) at 8.

the focus is on the mode of payment. If payment is to be made according to time spent on materials, the contract is one for work and services, otherwise, the contract is a sale.[71]

At times, a court has divided a hybrid contract into two separate contracts, one for the sale of goods and one for services, instead of putting the whole contract in one category. To the extent that the transfer of physical assets is concerned, the contract is one for the sale of goods, to be governed by Sales Acts. Under this test if a computer, for example, is sold to be installed in the buyer's office, two contracts are entered into: a contract for the sale of computer and a service contract for its installing.[72] In *Foster v Colorado Radio Corporation*, one party contracted to purchase the other's radio station, which included licence, good will, real estate, studios and furnishings.[73] The US Court of Appeals for the Tenth Circuit divided the original contract and applied UCC Article 2 to a small part of the contract dealing with sale of radio station's office equipment and furnishings which were movables and hence constituted *goods* within the UCC definition. The court concluded that the Article 2 applies to all sale of goods although they constitute an incidental part of the contract.[74]

In conclusion, although the necessity of distinguishing a contract for the sale of goods from one for services is no longer very demanding in the Anglo-Australian legal system, the test is still necessary for the application of UCC Article 2. Different tests have been adopted in order to distinguish the sale of goods from service contract. Since each test may be well

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71 At 9.

72 Squillante & Fonseca (ed), *Williston on Sales*, (CBC, New York, 5th ed 1992) at 36.

73 381 F 2d 222 (1967).

74 See Comments and Casenotes: "Dual Nature Contracts and the Uniform Commercial Code" (1968) 28 *Maryland Law Review* 136.

suited to particular cases, these tests might be helpful when such a distinction is necessary for the purposes of the Convention.

4.1.2. The Convention and the Distinction Between Sale of Goods and Service Contracts

Buy-back or offset transactions involve transferring certain machinery and equipment as well as providing some services, such as giving some technical guidelines, installing the machinery and equipment, constructing the project, and supervising the production process. In addition, sales transactions, even in their typical forms, often involve some measure of service, such as wrapping, delivering, after-sale servicing and installing.[75] Since the Convention is concerned with sale of goods, it is important to categorise these hybrid contracts as sale of goods or service contracts. For a better understanding, the hybrid contracts which can be found in buy-back or offset programs are categorised here into three groups: sales of equipment to be erected, sale of minerals to be exploited, and sale of goods to be manufactured.

4.1.2.1. Sale of Equipment to be Erected

When a trading party transfers certain machinery or equipment under a sales contract and undertakes in a separate contract to provide some relevant services, the first contract is a contract for the sale of goods within the meaning of the Convention and the second is one for work and services which is outside its scope.[76] Considering all the circumstances

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75 Quinn, *Quinn's Uniform Commercial Code Commentary and Law Digest* (WGL, Boston, 2nd ed 1991) para 2-106[A][3].

76 Article 3(2) of the Convention.

surrounding a transaction, a court or a tribunal may find persuasive grounds to split a mixed contract into a contract for sale of goods and one for services.[77] In these cases, that part of the contract dealing with the sale of goods is governed by the Convention and the other part dealing with supplying services falls outside its scope.[78] Similarly, if one party to a buy-back or offset arrangement undertakes to install or affix certain goods belonging to the other party or to a third party, the contract is one for work and services. However, in typical cases where sale of machinery or equipment is associated with providing services and there is no basis for separation, the Convention has set up a test by means of which these hybrid contracts could be placed in categories of sale of goods or service contracts.

Article 3(2) of the Convention reads: "This Convention does not apply to contracts in which the preponderant part of the obligations of the party who furnishes the goods consists in the supply of labour or other services". Instead of providing some objective measures, the Convention provides that a mixed contract is a sale contract unless a *preponderant* part of the obligations consists in the supply of labour or services.[79] Determining what constitutes a *preponderant* part is a source of difficulty because *preponderant* is an abstract word which suffers from ambiguity and imprecision.[80] One element in determining the preponderance of services could be their economic value as compared with the whole

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77 There must be compelling circumstances which provide good grounds for such a split. *Kahler v Midland Bank* [1950] AC 24 at 42; *Samarni v Williams* [1980] 2 NSWLR 389 at 395. The severability of a contract should be dealt with by reference to general principles of the Convention and in the absence of such principles, in accordance with the applicable law of the contract. Ferrari, "Recent Development: CISG: Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing" (1995) 15 *Journal of Law and Commerce* 1 at 64.

78 Inserting separate prices for the goods and services in a single contract could be rightly perceived as an indication to two contracts.

79 The word *preponderant* literally means a greater in weight, number, strength, importance etc. See for example *The Oxford English Dictionary* (Clarendon Press, Oxford, 2nd ed 1989).

80 At the Vienna Conference the UK delegation "proposed that the expression 'preponderant part' should be replaced by the more precise formula 'the major part in value' ". Lacking support, the UK delegation withdrew the proposal. Honnold, *Documentary History of the Uniform Law for International Sales*" (Kluwer, the Netherlands, 1989) at 462 & 464.

contract value.[81] The significance of the services provided relative to the goods supplied could be another element in determining the preponderant part. The parties' intention and the purposes of the contract may also be taken into consideration in determining whether or not the services involved are the preponderant part of the contract.[82] Thus, unless such a preponderance has been ascertained, the Convention applies to a mixed contract. For example, the ICC International Court of Arbitration found that the agreement for the supply of materials to be assembled in a hotel in Czechoslovakia was subject to the Convention because the provision of assembly services was secondary to the sale of materials.[83]

At times, one party to buy-back or offset undertakes to construct a project supplying necessary materials and equipment provided that the title in goods will be transferred when the project is constructed. Since the title in materials is to be transferred when they become part of an immovable thing,[84] a question arises as to whether or not these types of arrangements are covered by the Convention.[85] If skills and services employed do not constitute a preponderant part of the deal, the contract is subject to the Convention, even at the time of transferring the title, the materials are part of immovable things. It seems that

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81 Considering economic value of materials compared to the value of services was supported by the ICC International Court of Arbitration when it determined a mixed contract as one for the sale of goods for the purposes of the Convention. Ferrari, "Recent Development: CISG: Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing" (1995) 15 *Journal of Law and Commerce* 1 at 63.

82 "A two-part test involving a quantitative judgement of the agreement and a subjective judgment of the intent of the parties and the purpose of the agreement should be used." Richards, "Contracts for the International Sale of Goods: Applicability of the United Nations Convention" (1983) 69 *Iowa L Rev* 209 at 240.

83 Callaghan, "UN Convention on Contracts for the International Sale of Goods: Examine the Gap-Filling Role of CISG in two French Decisions" (1995)) 14 *Journal of Law and Commerce* 183 at 197.

84 In *Brooks Robinson v Rothfield* [1951] VLR 405 at 408-409, Dean J said: "When [the cabinet was] installed it served as a wall, and was part of the house itself. ... In my opinion, it sufficiently appears that plaintiff had, as part of its contract, to affix it to the house, that no property passed until it had done so, and that it was accordingly not a contract of sale of goods and sec. 9 of the Goods Act 1928 is no defence."

85 In Australia a contract to supply certain goods to be installed, provided that property is to pass only on installation, is outside of the coverage of *Sales of Goods Acts*. *Brooks Robinson v Rothfield* [1951] VLR 405.

the Convention applies to these cases because it has nothing to do with "the effect which the contract may have on the property in the goods sold".[86] It is, however, to be noted that if a contract for sale of immovable things is ascertained, the contract falls outside the coverage of the Convention. For example, if the supplier of materials sells them when they become part of a building or factory in such a way that their severance causes damage to the materials themselves or to the building, the contract is for immovable things which is outside the Convention.

In sum, if a buy-back or offset transaction involves sale of goods as well as providing services, the contract is one for sale of goods unless it is ascertained that the major part of the obligations is the supply of services. For example, in cases where goods are relatively complete in themselves but services are supplied to make them fully effective for the buyer's purposes the contract is one for sale of goods.

4.1.2.2. Sale of Minerals to be Exploited

When the subject-matter of a sales contract is immovables at the time of contracting but it will become moveable at the time of performance, a question arises as to whether such contracts are sale of goods within the meaning of the Convention. For example, in buy-back or offset arrangements one party may purchase oil or other minerals, attached to land at the time of concluding the contract, to be exploited. This problem stems from the fact that the Convention is relevant only to sale of *goods*, which implies their movability, although it has no explicit provision requiring that goods must be moveable. Honnold supports the idea that *goods* only refers to moveables by comparing the French and Spanish

86 Article 4(b) of the Convention.

versions of the Convention in which the word *merchandisers* and *mercaderias* have respectively been used referring to moveable tangible assets.[87] He also foreclosed any doubt by referring to a number of Articles which imply the notion of movability of the goods.[88] As a result, although there are no express provisions excluding immoveable things from its scope, there are persuasive indications that the Convention applies only to moveable things. The Convention provides no express or implied indications excluding the coverage of cases where minerals are sold to be exploited later. As a result, the Convention applies to the sale of gas, oil or other minerals if they are to be extracted later, because, although they are part of the land at the time of contracting, they will be moveable at the time of performance.[89]

A further source of difficulty arises when the buyer undertakes to exploit the minerals. In the *Uniform Commercial Code*, a distinction has been drawn between cases where the exploitation is carried out by the seller and those where it is to be carried out by the buyer. Under section 2-105(1) of the UCC, goods include things "attached to realty as described in the section on goods to be severed from realty (section 2-107)". Section 2-107 restricts the coverage of Article 2 to cases where minerals are to be severed by the seller, not the buyer: "A contract for the sale of minerals or the like (including oil and gas) or a structure or its materials to be removed from realty is a contract for the sale of goods within this Article *if they are to be severed by the seller*".[90]

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87 Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 101.

88 These relevant Articles are Article 35 dealing with quality and packaging, Article 46 about replacement or repair of defective parts, Articles 67-68 concerning shipment and damage during transit, Article 73 connected with delivery by instalments, and Articles 85-88 in regard to preservation and warehousing to prevent loss or deterioration. As above.

89 Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 102.

90 Section 2-107(1) of the UCC [emphasis supplied].

Can such a distinction be drawn with respect to the Convention? Since there is no indication at all within the Convention leading to such a conclusion, it seems that the Convention applies to the sale of minerals to be exploited either by the seller or the buyer.

In some cases one party to buy-back or offset may undertake to exploit a mine belonging to the other trading party and agrees to purchase some percentage of the output. If the services rendered by the first party and the commitment to purchase back the output are spelled out in separate contracts, the service contract falls outside and the purchase contract falls inside the coverage of the Convention. However, if a single contract provides that the first party has to exploit the mine and to be paid by the outputs, the contract is a service contract because its preponderant part consists in the supply of services.[91]

4.1.2.3. Sale of Goods to be Manufactured

When one contracting party orders some goods to be manufactured, the issue of a hybrid contract arises, because certain materials are to be processed through employing particular services. To determine whether the Convention applies to these contracts, two types of cases are to be distinguished:

First, the materials used in manufacturing belong to the manufacturer or producer. The position of the Convention as to these cases is clear since Article 3(1) provides that contracts for the supply of goods to be manufactured are to be considered sales within its scope. The Convention applies to these contracts, irrespective of whether or not the materials used constitute a dominant part of the contract as compared with the services and labour employed to produce those goods. This standpoint in categorising a hybrid contract

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91 Article 3(2) of the Convention.

is in line with the *end result* test prevalent in the Anglo-Australian legal system since the last century. In *Atkinson v Bell*,[92] "Bayley J expressed the opinion that where a person is employed to work up his own materials into a chattel, he cannot recover for work and labour."[93] In *Lee v Griffin*, Hill J said: "Wherever a contract is entered into for the manufacture of a chattel, there the subject-matter of the contract is the sale and delivery of the chattel, and the party applying it cannot recover for work and labour."[94] In this case, Crompton J remarked: "I certainly do not agree with the proposition, that value of the skill and labour, as compared to that of the material supplied, is a criterion by which to decide whether the contract be for work and labour or for the sale of a chattel."[95] As a result, when a trading party orders particular goods to be manufactured, the contract is for the sale of goods, irrespective of whether or not the value of materials exceeds the value of services.[96]

Second, the whole or part of materials to be used in manufacturing or processing belongs to the person ordering the processing. In other words, the person who orders certain goods to be manufactured supplies all or some of the materials needed in production or manufacturing. If the party ordering the goods to be manufactured sells the raw or unprocessed materials to the other party and undertakes to re-purchase them after such a process is made, both contracts are clearly within the scope of the Convention. However, in many cases the supplier of the materials does not transfer them, but gives them to the producer for a further process. Under Article 3(1) of the Convention, these cases are

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92 (1828) 8 B & C 277.
93 Quoted from *Clay v Yates* (1856) 1 H & N 73 at 75.
94 (1861) 1 B & S 272 at 276.
95 At above.
96 In *Cammell Laird v Manganese Bronze* [1934] AC 420, House of Lords held that a contract for the manufacture and delivery of a ship propeller was unquestionably a contract for the sale of future goods.

viewed as contracts for the sale of goods "unless the party who orders the goods undertakes to supply a substantial part of the materials necessary for such manufacture or production". As a result, those cases are excluded from the coverage of the Convention where the party giving the order undertakes to supply a *substantial* part of the material needed for such production. With respect to Article 3(1) two issues needed to be examined i) What are the criteria of being a substantial part? ii) Does the substantial part also include substantial services necessary for the production of the goods?

With respect to the first issue, the phrase *substantial* differs conceptually from *essential*;[97] for example, tyres are an essential part of a car but not a substantial one. For the purpose of the exclusion set forth in Article 3(1), it is not necessary nor sufficient that materials supplied by the party constitute an essential part of the production, but they must be substantial.[98] Since the word *substantial* lacks a precise meaning, it might be interpreted in different ways by different courts.

For the purpose of the *Trade Practices Act* 1974 (Cth), the term *substantial* has been considered by some courts in Australia. In *Radio 2UE Sydney v Stereo FM*, Lockhart J said: "The word 'substantial' is imprecise and ambiguous. Its meaning must be taken from its context. It can mean considerable or big ... It can also mean not merely nominal,

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97 However, in its French version, the phrase '*une part essentielle*' has been used.

98 Article 6 of the *Uniform Law on the International Sale of Goods* 1964 requires that material should be both essential and substantial. It provides: "Contracts for the supply of goods to be manufactured or produced shall be considered to be sales within the meaning of the present Law, unless the party who orders the goods undertakes to supply *an essential and substantial part* of the materials necessary for such manufacture or production" (emphasis supplied). In accordance with the UNCITRAL Yearbook, this Article had been kept unchanged during the first five sessions of the working groups, but later *essential* has been deleted without any official explanation. Compare different versions of Article 3 in UNCITRAL, *Yearbook* vol V (UN, New York, 1974) at 52; UNCITRAL, *Yearbook* vol VI (UN, New York, 1975) at 51; and UNCITRAL, *Yearbook* vol VIII (UN, New York, 1977) at 26. Perhaps, the change was made to bring the Article in line with Article 6 of the *United Nations Convention on the Limitation Period in the International Sale of Goods* 1974 which provides that this later "Convention shall not apply to contracts in which the preponderant part of the obligations of the seller consists in the supply of labour or other services".

ephemeral or minimal. Sometimes it is used in a relative sense, and other times to indicate an absolute size or quantity."[99] In *Tillmanns Butcheries v Australasian Meat Industry Employees' Union*, Deane J remarked: "The word 'substantial' is not only susceptible to ambiguity; it is a word calculated to conceal a lack of precision."[100] As a result, a court has to compare the materials supplied to other materials and services contributed by the producer. Certainly, a comparison between the value of materials provided and those used in production could be one key factor to ascertain the substantiality of the materials provided. The technical significance of materials may be considered as another factor. For example, if one party who orders certain products to be manufactured provides all the technical components and leaves the non technical ones for the manufacturer, a court might refuse to apply the Convention although the non-technical parts used by the producer are higher in value.[101]

With respect to the second question, it should be noted that buy-back or offset programs may involve contracts for the supply of goods to be manufactured or produced in which the party who orders the goods undertakes to supply substantial services necessary for such manufacture or production. For example, under a buy-back arrangement an Australian food processing company orders one million cans of food to be purchased from China on the condition that the Australian party undertakes to provide know-how, machinery and other technical assistance to enable the Chinese party to produce the canned food. It seems that the Convention applies to such cases, because the Convention only excludes those sales in which a substantial part of materials are supplied by the party who orders.[102] Since the

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99 (1982) 62 FLR 437 at 444.

100 (1979) 42 FLR 331 at 348.

101 Richards, "Contracts for the International Sale of Goods: Applicability of the United Nations Convention" (1983) 69 *Iowa L Rev* 209 at 231.

102 Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 109.

supply of facilities other than materials does not fall within the exclusion in Article 3, the Convention covers such cases.[103]

In conclusion, under buy-back or offset programs one party may provide the other with machinery, equipment, know-how, technical services or some material to enable the other partner to produce particular goods. The provider may also undertake to purchase back some percentage of those products. It is also common in offset programs that the provider of a given product, such as airplanes, undertakes to purchase a specific part of that product from the other party and incorporate it in the end product. If the material, machinery and other facilities provided by a trading partner are transferred to other party, the purchase of goods produced through using those facilities is obviously a contract for the sale of goods within the meaning of the Convention. However, if those materials, know-how or technical assistance are not transferred to the other party, but provided for the production process, the contract to purchase back the output is one for the sale of goods, unless the party who has made the order supplies a substantial part of the materials. If under an offset program, for example, a car producer sells a number of cars and undertakes to incorporate the other party's materials into the cars, the contract is one for the sale of goods unless the incorporated materials constitute a substantial part of the deal.

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103 The UK delegation at the Vienna Conference suggested that the exclusion of contracts for the supply of goods "if the party who ordered them undertook to provide the 'know-how' necessary for their production or manufacture". This proposal was rejected. In reply to this suggestion, the French delegate said that "he would be reluctant to see it consider the United Kingdom proposal, which would exclude from the scope of the Convention a category of contracts which were economically important, particularly of developing countries. The French proposal, by referring to 'materials', made it clear that a party supplying expertise would still be subject to the Convention". Honnold, *Documentary History of the Uniform Law for International Sales*" (Kluwer, the Netherlands, 1989) at 243.

4.2. Transfer of Intellectual Property

4.2.1. General Remarks

Many buy-back or offset programs involve agreements relating to technology transfer in the form of granting licences, providing know-how, supplying technical information and selling software. It is worthwhile discussing whether the Convention covers these contracts. This question stems from the fact that the Convention is relevant only to the sale of *goods*. Article 1(1) reads: "This Convention applies to *contracts of sale of goods* between parties whose places of business are in different States".[104] While the Convention has given no definition of *goods*, Article 2 excludes sale of certain things from the sphere of the Convention.[105] These excluded sales do not cover sale of licences, copyrights, know-how and so on. Thus, the application of the Convention to these contracts depends on the meaning given to *goods*.

It is widely accepted in national laws that *goods* refers to tangible movable property except money.[106] In Australia[107] and England[108] *goods* "includes all chattels personal other than

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104 Article 1(1) of the Convention [emphasis supplied].

105 Article 2 of the Convention provides:

> This Convention does not apply to sales:
> (a) of goods bought for personal, family or household use, unless the seller, at any time before or at the conclusion of the contract, neither knew nor ought to have known that the goods were bought for any such use;
> (b) by auction;
> (c) on execution or otherwise by authority of law;
> (d) of stocks, shares, investment securities, negotiable instruments or money;
> (e) of ships, vessels, hovercraft or aircraft;
> (f) of electricity.

106 *Chitty on Contracts,* vol 2 (Sweet & Maxwell, London, 27th ed 1994) at 1102; Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 101; Quinn, *Quinn's Uniform Commercial Code Commentary and Law Digest* (WGL, Boston, 2nd ed 1991) para 2-63.

107 Section 5 of the *Sale of Goods Act* 1923 (NSW); s3 of the *Goods Act 1958* (Vic); s 69 of the *Sale of Goods Act* 1895 (WA); s3 of the *Sale of Goods Act* 1896 (Qld); s3 of the *Sale of Goods Act* 1896 (Tas); s5 of the *Sale of Goods Ordinance* 1972 (NT); s5 of the *Sale of Goods Ordinance* 1954

things in action and money. The term includes emblements, industrial growing crops, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale".[109] In the UCC *goods* "means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than money in which the price is to be paid, investment securities (Article 8) and things in action".[110] Unlike these statutes, the Convention provides no definition of *goods* to clarify whether *goods* also includes intangible things.

It seems that transfer of intellectual property such as know-how, copyrights, patents, trade marks and other technical information is not a sale of goods for the purposes of the Convention, although particular goods may be subjected to these intellectual property rights.[111] Honnold observes that since *goods* refers to tangible, corporeal things, "sales of patent rights, copyrights, trademarks and 'know-how' are not governed by the Convention".[112] A German court has declared that *goods* refers only to corporeal moveable things.[113] Since the Convention does not define *goods* to be tangible, it is possible that other courts may view sale of intangible things as sale of goods within the meaning of the

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(ACT); and s60 of the *Sales of Goods Act* 1895 (SA). Section 4 of *Trade Practices Act* 1974 (Cth) provides that *goods* "includes (a) Ships, aircraft and other vehicles; (b) animals, including fish; (c) minerals, trees and crops, whether on, under or attached to land or not; and (d) gas and electricity".

108 Section 61 of the *Sale of Goods Act*, 1979 (UK).

109 Section 5 of the *Sale of Goods Act* 1923 (NSW).

110 Section 2-105(1) of the UCC.

111 Article 42(1) of the Convention provides:

> The seller must deliver goods which are free from any right or claim of a third party based on industrial property or other intellectual property, of which at the time of the conclusion of the contract the seller knew or could not have been unaware, provided that the right or claim is based on industrial property or other intellectual property.

112 Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 101.

113 Ferrari, "Recent Development: CISG: Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing" (1995) 15 *Journal of Law and Commerce* 1 at 65.

Convention.[114] The issue is more problematic with respect to computer software which will be discussed separately below.

4.2.2. Computer Software

While *goods* includes computer hardware and peripherals,[115] it is not clear as to whether or not software should be classified as *goods* within the meaning of the Convention. The issue of whether software is *goods* has been discussed in some Australian and US cases, although the issue has not been conclusively determined.[116]

In *Toby Construction Products v Computa Bar (Sales)*, Rogers J held that a sale of a computer system comprising hardware and software was a sale of goods.[117] Instead of determining whether or not software was *goods*, Rogers J examined the issue of the distinction between contracts for the sale of goods and contracts for work and labour. He said:

> It may be a debatable question whether or not the sale of computer software by itself is sufficient to constitute a sale of goods within the meaning of the legislation I am considering. However, I have no doubt that the sale of a system in toto is within the legislation. Equally I have no doubt that the contract was for the sale of a complete computer system.[118]

In *Triangle Underwriters v Honeywell* the sale of a turn-key computer system was held by the US Court of Appeals 2nd Circuit to be a sale of goods for the purpose of the UCC four year statute of limitations.[119] The court said: "Triangle bought Honeywell's equipment in

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114 Diedrich, "Maintaining Uniformity in International Uniform Law via Autonomous Interpretation: Software Contracts and the CISG" (1996) 8 *Pace International L Rev* 303 at 336.

115 Hughes & Sharpe, *Computer Contracts* (The Law Book Company, Sydney, 1987) at 35.

116 At 36.

117 [1983] 2 NSWLR 48.

118 At 54.

119 604 F 2d 737 (1979) at 742.

the hope it would outperform IBM's equipment - the essence of the contract was for the sale of goods. While certain services by Honeywell were contemplated, the contract remains one for sale if those services were merely incidental or collateral to the sale of goods."[120] As in *Toby*, this US case also failed to determine whether or not software by itself constitutes goods, although the court concluded that the contract was one for the sale of goods.

Since the way of transferring software may have some impact on its legal status, the application of the Convention to the sale of software will be discussed here in respect of two methods: i) cases where software is transferred through selling some tangible things; and ii) cases where software is downloaded via electronic means.

4.2.2.1. Transferring Software Through Tangible Goods

Software may be saved on discs, cassettes, chips or cards to be transferred to customers by selling tangible goods for consumer acquisition as *off-the-shelf*.[121] In these cases, a disc containing software is similar to video films, recorded cassettes or even books which are clearly classified as goods.[122] Software is generally supplied in packages including manuals and discs or CDs, similar to supplying other tangible goods. By analogy, it can be said that the sale of software in such circumstances is also a sale of goods within the meaning of the Convention, because software in these cases is viewed as a tangible finished product.[123]

120 At 742-43.

121 The product is supplied for general purposes, preserving all copyrights.

122 Corones, "Consumer Protection Laws Affecting Software Licences" in Hughes (ed), *Essays on Computer Law* (Longman Professional, Melbourne, 1990) at 296; Horovitz, "Computer Software as a Good Under the Uniform Commercial Code" (1985) 65 *Boston University L Rev* 129 at 151; Cavanagh, "The Supply of Computer Software - Goods or Services?" (1984) *Australian Business L Rev* 195 at 202.

123 Although it was expressly stated in an obiter dictum of a German court that sale of standard software is sale of goods for the purposes of the Convention, the court excluded sale of custom-

This argument has been supported by the US Court of Appeals, 3rd Circuit, in *Advent Systems v Unisys.*[124] The court said:

> Computer programs are the product of an intellectual process, but once implanted in a medium are widely distributed to computer owners. An analogy can be drawn to a compact disc recording of an orchestral rendition. The music is produced by the artistry of musicians and in itself is not a 'good', but when transferred to a laser-readable disc becomes a readily merchantable commodity. Similarly, when a professor delivers a lecture, it is not a good, but when transcribed as a book, it becomes a good. That a computer program may be copyrightable as intellectual property does not alter the fact that once in the form of a floppy disc or other medium, the program is tangible, moveable and available in the marketplace. The fact that some programs may be tailored for specific purposes need not alter their status as 'goods' because the Code definition includes 'specially manufactured goods'.[125]

These normal cases of selling software should be distinguished from cases where its copyright is given to a person under which the licensee is authorised to reproduce certain copies of that given software for re-sale or other purposes. It is difficult to classify these latter cases as sale of goods to fall within the sphere of the Convention.

In some US cases, an attempt has been made to draw a distinction between cases where software is tailor-made and cases where software is supplied as a general interest package. Accordingly, the latter cases are viewed as sales of goods, while the former as the supply of services.[126] With respect to the Convention, this distinction could be supported on a different ground. If software is to be produced under the specification of the buyer, the

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made software from its coverage. Ferrari, "Recent Development: CISG: Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing" (1995) 15 *Journal of Law and Commerce* 1 at 66.

124 925 F 2d 670 (1991).

125 At 675.

126 *Micro-Managers v Gregory* 434 NW 2d 97 (1988) at 100; *Wharton Management Group v Sigma Consultants* 582 A 2d 936 (1990) See also Phillips, "When Software Fails: Emerging Standards of Vendor Liability Under the Uniform Commercial Code" (1994) 50 *Business Lawyer* 151 at 158; Atiyah, *The Sale of Goods* (Pitman Publishing, London, 9th ed 1995) at 46.

contract can be one for services because the preponderant part of the obligation consists in the supply of labour and services.[127]

4.2.2.2. Transferring Software via Electronic Means

Software can be transferred via telephone lines or other communication links where the receiver computer downloads software from the source computer.[128] In *Pont Data Australia v ASX Operations*, a question arose whether a series of encoded electrical impulses which are capable of reception and interpretation by the subscribers' computers was *goods* within the meaning of the *Trade Practices Act*, 1974 (Cth).[129] Wilcox J, acknowledging that *goods* generally refers to tangible and visible objects, said that sale of encoded electrical impulses is sale of goods for the purposes of the *Trade Practices Act* by analogy to electricity which is expressly included in the Act.[130] In *ASX Operations v Pont Data Australia*, the Full Court of Federal Court rejected that argument on the grounds "one could not properly characterise the subscribers as purchasers of electricity, and therefore of goods, within the sense of s. 49".[131] However, the issue of whether goods include software has been left open by the Court.[132] In England such a contract would be a telecommunication service within the meaning of s4(3) of *Supply of Goods and Services Act*

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127 Article 3(2) of the Convention.
128 Scott, "Software as 'goods': nullum simile est idem" (1987) 3 *Computer Law & Practice* at 133.
129 (1990) 93 ALR 523.
130 At 558.
131 (1991) 27 FCR 460 at 468.
132 Concerning the issue of whether software is *goods*, the Court said:

> We should add that in *Toby Constructions Products Pty Ltd v Computa Bar (Sales) Pty Ltd* (1983) 2 NSWLR 48, Rogers J held that a sale of a computer system, comprising both hardware and software, was a sale of 'goods' within the meaning both of the Sale of Goods Act 1923 (NSW) and the warranties implied by Part V of the TP Act. His Honour said ... with reference to United States authorities, that he did not wish it to be thought he was of the view that software by itself may not be 'goods'. This is a question which is left open after the present appeal, which, as will be apparent, has decided a narrower point.

ASX Operations v Pont Data Australia (1990) 27 FCR 460 at 468.

1982.[133] However, the applicability of the Convention on sale of software downloaded via telephone or other communication links is not clear.

In conclusion, since the Convention provides no definition of *goods*, avoiding using the term *tangible*, it is left to the court or tribunal to interpret this term as either including or excluding the sale of software. If visibility and tangibility is an essential element for something to be *goods*, it can be said that software is tangible when it is read through a device such as computer.[134] There is a trend in recent US cases to treat software as goods, irrespective of their way of conveyance.[135] For example, in *Communications Groups v Warner Communications*, the Civil Court of the City of New York said: "Regardless of the software's specific form or use, it seems clear that computer software, generally, is considered by the courts to be a tangible, and movable item, not merely an intangible idea or thought and therefore qualifies as a 'good' under Article 2 of the UCC."[136] On the other hand, a broad interpretation of *goods* for the purposes of the Convention to cover software creates an opportunity for the international community to avail themselves of the advantages of the most successful uniform law in a booming area of business.

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133 At 135.

134 In *Pont Data Australia v ASX Operations* (1990) 93 ALR 523 at 558, Wilcox J said:

> The word [goods] generally refers to tangible and visible objects; although it is notable that both the *Oxford English Dictionary* and the *Macquarie Dictionary* define 'goods' or 'goods and chattels' as referring merely to 'moveable property', without further limitation.

135 *Communications Groups v Warner Communications* 527 NYS 2d 341 (1988); *Advent Systems v Unisys* 925 F 2d 670 (1991); and *Colonial Life v Electronic Data System* 817 F Supp 235 (1993).

136 527 NYS 2d 341 (1988) at 344.

4.3. The Contracts of Agency and Distribution

One reason underlying the engagement in countertrade practices is to use the market facilities of a trading partner to access international markets.[137] Under a countertrade arrangement, the trading partner may agree to market particular products as an agent or as a distributor. Agency and distributorship agreements are two well-known vehicles in international relations to sell products abroad, without investing or establishing a subsidiary there.[138] In examining the application of the Convention to agency or distribution contracts, reference should be made at the outset to the nature of these two transactions.

4.3.1. Agency[139]

The contract of agency refers to a legal relation under which a person, the principal, authorises another person, the agent, to act on behalf of the principal.[140] In international countertrade, an agent may be authorised to conclude sales contracts with third parties on behalf of the exporter. Alternatively, the agent may be authorised only to introduce the customers to the exporter leaving the decision to the principal.[141] In any event, the agent

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137 See Chapter 2 pages 54-60.

138 Jackson & Davey, *Legal Problems of International Economic Relations* (West Publishing Co, St Pual Minn, 2nd ed 1986) at 1044.

139 It is also referred to as *sales representative*. Bauman, "Specific Contractual Arrangements, International sales representative and distributorship agreements" (1979) 4 *North Carolina J International L & Commercial Regulations* 141 at 141.

140 "Agency is a comprehensive term, which has more than one meaning. In its broadest sense it includes every relation in which one person acts for or represents another by his authority. In the more restricted sense in which the term is used in the law of principal and agent, agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." 2A *Corpus Juris Secundum* at 551; see also *Chitty on Contracts,* vol 2 (Sweet & Maxwell, London, 27th ed 1994) para 31-001.

141 Schmitthoff, *Schmitthoff's Export Trade: The Law and Practice of International Trade* (Stevens, London, 9th ed 1990) at 261.

acts as an intermediary between the customer and the exporter rather than as an independent party.

A contract of agency certainly falls outside the scope of the Convention, because the agent does not purchase any goods from the exporter. The agent only facilitates the sale and purchase between the exporter and the customer. In *Ytong v Lasaosa*, the argument of Lasaosa that their contractual relationship was either a franchise or industrial agent was rejected by the French Court of Appeals on the grounds that no aspect of the contract provided a mandate given by Ytong to Lasaosa.[142] Since the exporter sells the products directly to the buyer in the foreign country, a sales contract is concluded between the exporter and the customer rather than between the exporter and the agent or between the agent and the customer. As a result, although the agency contract is outside the coverage of the Convention, the sale between the exporter and the customer is governed by the Convention.

4.3.2. Distribution

Under an international distribution arrangement, an exporter sells to an importer certain products to be resold within a given market.[143] The main factor distinguishing a distributorship from an agency is that the distribution company purchases the goods from the exporter to resell them to its customers. The distribution company takes the title to the goods and has to pay the price to the exporter, irrespective of whether it has been paid by

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142 Callaghan, "UN Convention on Contracts for the International Sale of Goods: Examining the Gap-Filling Role of CISG in two French Decisions" (1995)) 14 *Journal of Law and Commerce* 183 at 190; "Interpretive Decisions Applying CISG: Journal Of Law & Commerce Case II" (1995) 14 *Journal of Law and Commerce* 209 at 213.

143 Cable, "International Distribution Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990 at 57.

the customer or not. While an agent acts on behalf of its principal, a distribution company sells the goods for its own account.[144] As a result, the distributor has direct responsibility towards its customers and takes its profit from the difference between the purchase price and the selling price, while the agent is paid by a commission. To examine the applicability of the Convention to distribution arrangements, they are categorised here into four groups as follows:

i) If under a distribution agreement, the distributor undertakes to purchase specific goods during a particular time, the contract is a sale for the purposes of the Convention. For example, if a distributor agrees to purchase 1000 computers from the exporter during one year, the agreement is a sales contract. In these cases, however, the distributor may be required to comply with the exporter's instructions regarding the advertisement, after-sales services, appointing another distributor, selling within a specific territory and the like. It seems that such additional obligations required by the seller do not change the nature of the agreement so as to push it out of the Convention.

ii) The distribution contract may be a general agreement by which the exporter grants an exclusive[145] or non-exclusive right of distributing to an importing company for an indefinite duration.[146] Accordingly, the distributor has to forward to the exporter all orders made by the customer in its own name. In this context, this agreement is not a sale within the

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144 Jordan, "International Distribution and Agency" in Sacks & Malbon (ed), *Australian Export Manual* (Longman Professional, Melbourne, 1992) at 70-71.

145 Under an exclusive right of representation, the principal shall not appoint another distributor within the agreed territory. See Schmitthoff, *Schmitthoff's Export Trade: The Law and Practice of International Trade* (Stevens, London, 9th ed 1990) at 260.

146 Sales, "Termination of Sales Agents and Distributors in France" (1983) 17 *International Lawyers* 741; Simons, "Termination of Sales Agents and Distributors in Belgium" (1983) 17 *International Lawyers* 752.

meaning of the Convention.[147] Although such arrangements can be classified as contracts to sell, they constitute a sales contract for the purpose of the Convention only if they are sufficiently definite.[148] A proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provisions for determining the quantity and the price. It should be noted, however, that subsequent sales contracts entered into as a result of the general agreement are subject to the Convention. For example, a court in the Netherlands held that a distribution contract was outside the coverage of the Convention because the distribution contract did not by itself constitute a contract for sale of goods although it applied to subsequent sales contracts made under the distribution arrangement.[149]

iii) The situation becomes more complex if under a distribution agreement a minimum purchase has to be made during a specific period of time, although the agreement as a whole is indefinite. For example, an importing company in India is granted an exclusive right of distribution in Delhi for an indefinite time, provided that a minimum sale is made annually. In such cases, it seems that the Convention applies to the arrangement requiring definite purchase of that minimum. To the extent that the distributor has to purchase a certain quantity of goods, the distributorship agreement is a sales contract within the meaning of the Convention.

iv) When goods are to be transferred directly from the exporter to the customer, the agreement between the exporter and the intermediate party is not a sale, whatever terms the parties may select for their relationship. As a result, if under a distributorship contract, the

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147 Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 103.

148 Under Article 14(1) of the Convention a proposal for concluding a contract must be sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance.

149 Del Duca, "Practice Under the Convention on International Sale of Goods: A Primer for Attorneys and International Traders (Part I)" (1995) 27 *Uniform Commercial Code Law J* 331 at 349.

distributor only solicits the purchase by the customer, the agreement is an agency even if the parties have chosen a different name for the contract.[150]

Conclusion

Countertrade arrangements may involve different contracts from a simple exchange of goods for goods to the complex transactions of buy-back and offsets which include the sale of goods and services, transfer of technology, granting licences and know-how, franchises, agency, investment, distributorships and so on. In this chapter an attempt has been made to examine the application of the Convention to the most popular forms of transactions which may be found in countertrade packages. In determining whether the Convention applies to a specific arrangement, reference should be made to *sale of goods* to see whether that given arrangement constitutes a contract for the sale of goods within the meaning of the Convention. The interpretations of *sale of goods* should be made by considering the international character of the Convention and the need to promote uniformity in its application.

There are certain elements which make the Convention relevant to countertrade contracts. First, the Convention does not require that the price must be in money. Second, the mixed

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150 In the US, it is also necessary to deal with the question of whether distribution agreements are contracts for the sale of goods. In *Lorenz Supply Company v American Standard* 300 NW 2d 335 (1980), the Court of Appeals of Michigan said that the distributorship is not a sales contract because the "agreement did not require Lorenz to buy a certain quantity of goods or, indeed, to buy any goods from the defendant in the future. This agreement envisioned an ongoing economic relationship between Lorenz and defendant for their mutual benefit, rather than a contract of sale." At 338. The Supreme Court of Michigan endorsed the decision of the Court of Appeals to the extend that the distribution contract is not a contract for the sale of goods. It added, however, that since Article 2 of the UCC covers all *transaction in goods*, it generally covers distribution agreements except those rules which are exclusive to contracts for the sale of goods such as s2-201 dealing with the statute of frauds. *Lorenz Supply Company v American Standard* 358 NW 2d 845 (1983) at 851.

contracts are considered sale of goods unless it is ascertained that the preponderant part of the contract consists in services. Third, contracts for the supply of goods to be manufactured are sale of goods unless substantial materials are provided by the party who orders. Finally, the Convention used *goods* instead of tangible things which can be interpreted to include software or even other intellectual property. Moreover, a court may find compelling circumstances to split a countertrade package into different contracts to apply the convention to that part which is perceived as one for the sale of goods. However, there are two points to be borne in mind in drafting countertrade contracts. First, since every court or tribunal may interpret the Convention and the terms of a countertrade contract differently, there is no certainty as to the application of the Convention to countertrade contracts. To avoid such uncertainty, the countertrading parties should express whether or not the Convention should apply to their contracts. Second, since the Convention has been tailored for a normal sale of goods, some of its provisions may need to be varied or derogated from in response to their particular needs. Alternatively, the parties may want to use pre-prepared standard forms or they may want to select some other general rules to govern their contracts. This alternative is the focus of the next Chapter.

CHAPTER 6

General Conditions and Standard Forms of Countertrade

Introduction

The diversity of national laws surrounding international trade transactions may create unexpected legal consequences for the contracting parties because the legal effects given to the contract may vary from jurisdiction to jurisdiction. One way to overcome such uncertainty is to agree on a choice-of-law clause to subject the contract to a particular legal system, discussed in detail in Chapter 4. Another way is to make the substantive rules of national laws uniform so that the contract will be governed by same rules in different jurisdictions. The Vienna Sales Convention, as the most successful attempt in making national laws uniform in regard to international sale of goods, has been discussed in the previous chapter. The third option is to incorporate into the contract a set of general rules prepared in advance or make self-regulatory contracts. The parties using this method wish to leave little to be decided in accordance with a foreign law, whatsoever it may be. This chapter focuses on cases where traders equip themselves with previously prepared general conditions, standard forms or standard terms to overcome the problem of uncertainty caused by diverse national laws as well as to save time and money in drafting detailed contracts term by term for every individual case.

The use of general conditions, standard forms or standard terms is based conceptually on the principle of party autonomy according to which the parties to a contract are supposed to be the best persons to decide what rights and obligations should arise from the contract. By incorporating a set of general rules into their contracts, the parties make their own regulations according to which the contract is to be effective. These general rules, known as *general conditions*, function as a legal system which regulates the parties' contractual relationship. Through affixing a set of general rules, the parties wish to create their own legal regime within which the contract is to be construed and effective. In some cases, the parties use standard form agreements which spell out the rights and obligations of the parties in detail. There are certain blanks in the form to be completed by the parties. By filling in the gaps, such as the parties' names, the kind of products, quantity and price, the standard form becomes a final draft to be signed. In addition to affixing a set of general conditions and filling out a standard form, the parties may incorporate into their contract certain standard terms prepared previously regarding a specific aspect of the contract. By using such standard terms, the parties want to avoid the different meanings which may be given to them in various jurisdictions.

The general conditions or standard forms may be prepared generally for international transactions or specifically for countertrade purposes. Drafting countertrade contracts in the light of a specific set of general conditions, or using standard forms or standard terms, requires an awareness of their implications on the rights and obligations of the parties. This chapter discusses the advantages and effects of using general conditions, standard forms and standard terms in drafting countertrade contracts. Since certain guides have also been prepared by international bodies to assist the parties to cope with the countertrade difficulties, a brief discussion of them is necessary. These guides highlight the key difficulties of countertrade practices suggesting some flexible solutions. As a result, the discussion here continues in respect of four issues: i) affixing a set of general rules to countertrade contracts; ii) using standard countertrade forms; iii) incorporating certain standard terms into countertrade contracts; and iv) the guides prepared by international bodies to assist the parties to draft countertrade contracts.

1. General Conditions

1.1. Introductory Remarks

The impact of national rules in a domestic context on commercial transactions is twofold: determining mandatory rules which parties cannot vary; and a gap-filling function as to those terms left undecided in the contract. When a customer, for example, decides to buy a sewing machine, the parties may enter into a sale contract by agreement on the kind of product, the price, and a one-year guarantee. The parties rarely go further to express in detail other aspects of the contract such as discharge, rescission, implied conditions and warranties, the time of transfer of risk or property, and remedies for breach of contract. In these circumstances, the law of that particular jurisdiction within which the deal has been concluded fills all these gaps by applying certain terms based on the parties' presumed intention. On the other hand, the law of that jurisdiction may contain mandatory rules which invalidate a term restricting the liability of the seller in terms of unmerchantability of the goods or non-conformity with samples. Determining the governing law allows the parties to anticipate the legal consequences of the contract, enabling them to be fully aware of the actions that should be followed if a dispute arises. Hence, in internal economic relations the law implies certain terms based on the presumed intentions of the parties. As a result, the parties may not need to draft a detailed contract.

At the international level, however, a transaction may be governed by different legal systems which may result in different legal consequences, because the issues left unmentioned are to be settled in accordance with the law applicable to the deal. The certainty and legal security of internal economic activities are not available in the same way in international transactions. Moreover, even in cases where the application of a particular law is assured, that law may not be an appropriate one because it is not sufficiently developed or its rules are not well-suited to a particular transaction. The problem is aggravated by the fact that obtaining accurate information on a foreign legal system is not always easy. In these circumstances, the parties to a countertrade contract may wish to incorporate into the contract a particular set of rules which are suitable to their needs. A typical example of general conditions is the Vienna Sales Convention in cases where its application requires the parties' agreement. In these cases, the Convention shapes and regulates the legal consequences of the contractual terms, completing the contract with respect to those issues left unmentioned.

1.2. Functions and Advantages of General Conditions

General conditions are a set of pre-prepared general terms which are similar in structure to a national codified law. They function as the law of the contract regulating rights and obligations of the parties in detail, so that the need to refer to a national law arises only in rare situations.[1] By incorporating a set of general conditions into the contract, it becomes unnecessary to draft a lengthy contract, predicting full contractual aspects. This avoids time-consuming and expensive alternatives. General conditions help the parties to simplify the contract and to focus on the more important issues in their negotiation process.[2] It is to be noted that since general conditions are a set of general terms, the parties still have to make their own contract as in ordinary cases.[3] When particular general conditions are incorporated into the contract, the contents of the contract need to be shaped in accordance with the terms set forth in the general conditions.

The incorporation of general conditions to any transaction requires the consent of the parties because of their optional character. There is also no limitation on the use of them either in whole or in part. In order to choose particular general conditions as rules of law governing the contract, the contracting parties have to make an express reference to them. A full text of the general conditions may be attached to the contract to avoid any subsequent claims of lack of awareness, particularly if the given general conditions are not well-known. When general conditions are in a language differing from the language of either the negotiations or the contract, a national court may disregard them as part of the contract.[4] To avoid such a problem, the general conditions should be affixed in the same language as the contract or an express acknowledgment of the issue should be inserted into the main body of the contract. If the whole set of general conditions seems unnecessary to

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1 UNCITRAL, *Yearbook* vol I, (UN, New York, 1968-1970) at 28.

2 Zhenpu, "The Experience of Economic Operators from Developing Countries" in UNIDROIT, *International Uniform Law in Practice* (Oceana Publications, New York, 1988) at 408.

3 Benjamin, "The ECE General Conditions of Sale and Standard Forms of Contract" (1961) *J Business L* 113 at 122.

4 For example, in Germany such general conditions are not regarded as an integral part of the contract. Sarcevic, "Standard Forms and General Conditions" in Voskuil & Wade (ed), *Hague-Zagreb Essays 4, on the Law of International Trade* (TMC Asser Instituut, the Hague, 1983) at 144.

be incorporated, a selected part which is relevant to the particular contract may be incorporated.

In cases where general conditions are unsuitable to be incorporated into a countertrade contract, they may be used as a guide for drafting the contract.[5] They may assist the contracting parties to identify and develop solutions for the main legal issues which need to be mentioned in a transaction. General conditions have commonly been drafted by international agencies, so a neutral terminology is often adopted avoiding a particular terminology which may have different meaning in different places. For example, the use of either the term *force majeure* or *frustration* may bear a particular meaning in civil law or common law respectively.[6] By consulting the general conditions, the parties avail themselves of useful experience in dealing with such problems. Through considering general conditions, the parties may avoid using either *force majeure* or *frustration* by setting out exact circumstances which will relieve a party from its obligations or by using neutral terminology. As a result, general conditions can be of assistance in predicting the main legal issues involved, in providing potential solutions and in providing appropriate terms and expressions to be adopted.

1.3. Comparison Between a National Law and General Conditions

Since the relationship between general conditions and a contract is similar to the one between a national law and a contract, a comparison between general conditions and the national law is worthwhile. National law (eg a Sale of Goods Act) and general conditions

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5 Bonell, "Unification of Law by Non-Legislative Means" (1992) 40 *American J Comparative L* 617 at 628.

6 Benjamin, "The ECE General Conditions of Sale and Standard Forms of Contract" (1961) *J Business L* 113 at 125.

are similar in providing a context within which a transaction has to be effected. Both regulate and shape rights and obligations of the parties, providing solutions to issues that the parties have failed to anticipate in the contract. However, although the application of a national legal system generally does not need the parties' agreement, the application of general conditions always requires the consent of the parties. Consequently, if the parties fail to express the law governing the contract and their intention is not clear, the law of a country with which the contract has the closest and most real connection would be determined as the proper law of the contract.

Further, and even more importantly, general conditions are not enacted by an authorised legislature, such as a parliament. They do not have the force of law. The authority of general conditions derives from the principle of party autonomy which is accepted in most legal systems. It is a key question whether or not a contract may come into existence independently from national laws. Under the prevalent theory, a contract inevitably comes into existence by reference to a national legal system. Thus, the general conditions incorporated into the transaction get their enforceability from that national law governing the contract. This brings about three important results. First, the incorporation of general conditions into the contract must be honoured by the law governing the contract. Second, general conditions are effective so far as they do not violate the mandatory rules of that legal system. Third, since no general conditions can cover all variations and contingencies connected with a particular commercial contract, the issues arising from the contract for which the general conditions have no solution must be settled in accordance with the rules of that law.[7] Nevertheless, there is a growing trend where arbitration is agreed to be the

7 Kopelmanas, "International Conventions and Standard Contracts as Means of Escaping from the Application of Municipal Law II" in Schmitthoff (ed), *The Sources of the Law of International Trade* (Stevens, London, 1964) at 124.

sole method of dispute settlement, to see general conditions being honoured by arbitrators autonomously from any national legal system.[8]

1.4. General Conditions for Countertrade Contracts

On the international level, a number of general conditions have been drawn up to accelerate the formation of international contracts and to eliminate uncertainties surrounding such transactions. These general conditions, resulting from a lot of research and studies, have been elaborated by practical experience and the usage prevailing in a number of different types of business. They may have been prepared for general purposes or for only a particular commodity or specific transactions.[9] The International Institute for the Unification of Private Law (UNIDROIT) and the United Nations Economic Commission for Europe (ECE) are two international bodies which have sponsored the drafting and publishing of a number of general conditions for commercial transactions in general or for specific transactions or trade fields. Below, UNIDROIT Principles and certain ECE general conditions will be discussed as the most popular and elaborated general conditions which may be used for countertrade purposes.

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8 Bonell, "The UNIDROIT Principles of International Commercial Contracts: Why? What? How?" (1995) 69 *Tulane L Rev* 1121 at 1144.

9 According to a survey of the collected general conditions made by UNCITRAL, general conditions could be classified into three groups: i) those relating to a certain kind of commodity (eg groundnuts) or a particular type of commodity (eg West African groundnuts); ii) those applicable to a certain group of commodities (eg cereals); and iii) those covering all commodities without exception. UNCITRAL, *Yearbook* vol II, (UN, New York, 1971) at 67.

1.4.1. UNIDROIT Principles

The elaboration of general principles of contract law has been included in the Work Program of UNIDROIT since 1971.[10] In 1980 a special working group, composed of academics, high ranking judges and civil servants from major legal systems of the world, was set up to prepare the various draft chapters of the Principles. It was not until 1994 that UNIDROIT published a set of general conditions named *Principles of International Commercial Contracts.* (UNIDROIT Principles).[11]

Although the Principles are modelled on the Vienna Sales Convention, they are different in a number of respects.[12] At the outset, unlike the latter, the Principles have not been drafted to be adopted as an international convention. The focus of the Principles has been on producing a balanced set of rules to be used throughout the world, regardless of diverse legal traditions and different political or economic conditions.[13] By contrast, since the Vienna Sales Convention has been drafted to be adopted as an international treaty, its contents have been shaped in such a way to gain maximum support from various countries with different legal traditions. Thus, some controversial but important issues have been deleted from the Convention to safeguard its universality. Under Article 4, for example, the validity of the contract and the issue of passing the title were excluded from the scope of the Convention. One key reason for this exclusion was wide differences of views between national systems which made reconciliation and compromise difficult.[14] The Principles were

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10 UNIDROIT, *Principles of International Commercial Contract* (UNIDROIT, Rome, 1994) at vii.

11 UNIDROIT published the Principles with explanatory comments in a book entitled "UNIDROIT, *Principles of International Commercial Contract* (UNIDROIT, Rome, 1994)".

12 Garro, "The Gap-Filling Role of the UNIDROIT Principles in International Sales Law: Some Comments on the Interplay Between the Principles and the CISG" (1995) 69 *Tulane L Rev* 1149 at 1155ff.

13 UNIDROIT, *Principles of International Commercial Contract* (UNIDROIT, Rome, 1994) at viii.

14 Nicholas, "The Vienna Convention on International Sales Law" (1989) 105 *Law Q Rev* 201 at 207.

not hampered by such obstacles and therefore have been drafted more maturely and broadly than the Convention.[15]

Secondly, the scope of the Principles is more extensive than the Convention. While the Convention only deals with sale of goods with a number of exceptions,[16] the Principles cover a broad range of commercial contracts. The opening remarks of the Principles state that these "Principles set forth general rules for international commercial contracts".[17] The scope of the Principles, therefore, covers all transactions having commercial and international features. It is to be noted that *commercial contracts* by no means reflect the distinction traditionally made in some legal systems between *civil* and *commercial* transactions. The idea is rather to exclude *consumer transactions* from the scope of the Principles.[18] As a result, two sets of commercial transactions are beyond the scope of the Principles: consumer and domestic transactions.

Third, since the Convention is a treaty entered into by contracting countries, its application may not need the parties' agreement.[19] By contrast, the application of the Principles always needs the consent of the parties.[20] The Preamble to the Principles provides: "They shall be applied when the parties have agreed that their contract be governed by them". It should

15 Perillo, "Unidroit Principles of International Commercial Contracts: the Black Letter Text and a Review" (1994) 63 *Fordham L Rev* 281 at 283.

16 Article 2 of the Convention provides a list of sales not covered by the Convention. See also Chapter 5, pages 170-171.

17 UNIDROIT, *Principles of International Commercial Contract* (UNIDROIT, Rome, 1994) at 235.

18 At 2.

19 For more details see Chapter 5, pages 169-170.

20 In cases where the parties agree that the contract should be governed by "general principles of law (Lex Mercatoria)", some scholars believe that UNIDROIT Principles should apply. Bonell, "The UNIDROIT Principles of International Commercial Contracts: Why? What? How?" (1955) 69 *Tulane L Rev* 1121 at 1144; Ferrari, "Defining the Sphere of Application of the 1994 'UNIDROIT Principles of International Commercial Contracts' " (1955) 69 *Tulane L Rev* 1225 at 1230. For a different opinion see Viscasillas, "UNIDROIT Principles of International Commercial Contracts: Sphere of Application and General Provisions" (1996) 13 *Arizona J International and Comparative L* 381 at 398.

also be noted that the parties are free "to exclude the application of these Principles or derogate from or vary the effect of any of their provisions, except as otherwise provided in the Principles".[21]

As a result, the scope of the Principles is sufficiently broad to cover countertrade arrangements. Although the reciprocal nature of countertrade contracts has not been considered in drafting the Principles, they are flexible enough to be used for countertrade purposes. The use of the Principles provides an opportunity for the parties to a countertrade agreement to avail themselves of advanced general conditions hard to find in any one national legal system. The incorporation of the Principles into a countertrade contract creates certain benefits for the parties because most questions arising from an international contract are effectively dealt with in the Principles. The Principles, composed of a Preamble and 119 Articles, are divided into seven chapters: *General Provisions, Formation*, *Validity*, *Interpretation*, *Content*, *Performance*, and *Non-Performance*. They provide a comprehensive basis for regulating and determining the duties and rights of the parties. Moreover, they are sufficiently flexible to be amended easily to fit countertrade contracts.

It is worthwhile here to highlight a number of distinguishing features of the Principles which ensure fair dealing between the parties, a point which is essential in countertrade arrangements requiring fulfilment over a number of years.

i) GOOD FAITH - Under Article 1.7 each party must act in accordance with good faith and fair dealing in international trade, a duty which may not be excluded or limited by the parties. The duty of acting in good faith is also extended to the negotiation process.

21 Article 1.5 of the Principles.

According to Article 2.15, although parties are free to negotiate and are not liable for failure to reach an agreement, if they negotiate or break off negotiations in bad faith, they are liable for the losses caused to the other party. A case of bad faith will occur if one party enters into or continues negotiations intending to not reach an agreement.[22]

ii) Duty of Confidentiality - The Principles provide no general duty of disclosure of the information given by a party in the course of negotiations. However, if particular information is given as confidential by one party, the other party is under a duty not to disclose that information or to use it improperly for its own purposes, irrespective of whether a contract is subsequently concluded or not.[23]

iii) Standard Terms - Article 2.19 (2) defines standard terms as "provisions which are prepared in advance for general and repeated use by one party and which are actually used without negotiation with the other party". To support the party which accepts the other party's standard terms, Article 2.20 declares that terms contained in standard terms, which are of such a character that the other party could not reasonably have expected it, are not effective unless they have been expressly accepted by that party. Moreover, if any inconsistency occurs between a standard term and a term which is not a standard one, the latter prevails.[24]

iv) Gross Disparity - One of the more interesting provisions of the Principles is Article 3.10 which permits a party to avoid a contract in cases where there is a gross disparity between the obligations of the parties. When the contract or an individual term of it gives one party an unjustifiably excessive advantage, the disadvantaged party is entitled to avoid

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22 Article 2.15(3) of the Principles.
23 Article 2.16 of the Principles.
24 Article 2.21 of the Principles.

the contract or to request an amendment of the contract terms adjusting them to reasonable commercial standards of fair dealing. To ascertain a case of unjustifiably excessive advantage, regard is to be had to the other party's dependence, economic distress or urgent needs, or its improvidence, ignorance, inexperience, or lack of bargaining skill.[25] These provisions are a ground upon which a party to an unconscionable countertrade contract may obtain avoidance or amendment of those terms giving the other party excessive advantage.

v) **HARDSHIP** - Many types of countertrade have to be fulfilled over years where the performance of the contract may become more onerous for one of the parties. In accordance with the Principles, performance must be rendered as long as a case of hardship does not occur. Article 6.2.2 defines hardship as a situation where the occurrence of events fundamentally alters the equilibrium of the contract, provided that: "a) the events occur or become known to the disadvantaged party after the conclusion of the contract; b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract; c) the events are beyond the control of the disadvantaged party; and d) the risk of the events was not assumed by the disadvantaged party". In the case of hardship, Article 6.2.3 entitles the disadvantaged party to request renegotiation. Upon failure to reach agreement, either party may resort to the courts.

vi) **EXEMPTION CLAUSES** - Article 7.1.6 permits a court to strike down abusive or unconscionable contract terms which limit or exclude one party's liability for non-performance. An exemption clause may be dishonoured by a court if, with reference to the purpose of the contract, it is grossly unfair.

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25 Article 2.10(1)a of the Principles.

As a result, the Principles are a set of general rules providing a model of recent developments in contract law. They might be well-suited for countertrade contracts as a supplement to the contractual terms or as a guide for drafting countertrade contracts.

1.4.2. ECE General Conditions

This century has witnessed the emergence of many trade associations specialising in various international commodity trades. Most of them have devised their own standard contracts which differ from trade to trade or from association to association. In addition to their diversity, they have often been drawn up in a way advantageous to either sellers or buyers, with no fair balance between the parties' rights and obligations.[26] The Economic Commission for Europe (ECE)[27] has formulated and disseminated a number of general conditions to provide a fair balance between the parties' obligations in order to replace those numerous standard contracts. The purpose of ECE general conditions is well demonstrated by an official commentary:

> From the point of view of ... importers and exporters alike, such unification appeared essential, facilitating the conduct and conclusion of negotiations for both parties by giving them a single text to refer to in place of the innumerable general conditions of sale now used by the industry, which differ greatly from country to country and even within a single country.[28]

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26 UNCITRAL, *Yearbook* vol I, (UN, New York, 1968-1970) at 28; Schmitthoff, "The Unification or Harmonisation of Law by Means of Standard Contracts and General Conditions (1969) 17 *International & Comparative L Q* 551 at 560-561.

27 The Economic Commission for Europe was set up in 1947 by the United Nations Economic and Social Council. It is the oldest regional commission created by the United Nations. Benjamin, "The ECE General Conditions of Sale and Standard Forms of Contract" (1961) *J Business L* 113 at 113.

28 Commentary on the General Conditions for the Supply of Plant and Machinery for Export, Preliminary Remarks 2 (1953); quoted from Michida, "Possible Avenues to Preparation of Standard Contracts for International Trade on a Global Level" in Honnold (ed), *Unification of the Law Governing International Sales of Goods* (Librairie Dalloz, Paris, 1966) at 259.

Some of the more important ECE general conditions are: *General Conditions for the Supply of Plant and Machinery for Export* (Form No 188); *General Conditions for the Supply and Erection of Plant and Machinery for Import and Export* (Form No 188A); *General Conditions for the Supply of Plant and Machinery for Export* (Form No 547); *General Conditions for the Supply and Erection of Plant and Machinery for Import and Export* (Form No 574B); and *General Conditions of Sale for the Import and Export of Durable Consumer Goods and of other Engineering Stock Articles* (Form No 730).[29] The issuance of general conditions by the ECE has been a relatively successful effort to provide a basis for drawing up international transactions independent from national laws.[30]

The general conditions drawn up by the ECE in relation to a particular trade can be used for countertrade purposes. For instance, countertrade arrangements in the form of buy-backs or offsets often involve the supply and erection of plant and machinery. One of the above-mentioned general conditions may be relied on as an appropriate legal framework instead of referring to a national law. The use of ECE general conditions enables the countertrading parties to focus on the more important issues benefiting from a balanced set of rules created by a UN body. It should be stressed that these general conditions are not in the format of a contract, but rather provide a set of provisions which frame the parties' rights and obligations, completing those issues the parties fail to agree on.[31] As a result, there are a number of important issues, such as the application of a particular set of general conditions, the price, the terms of payment and the like, which must be included in the contract. In

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29 These General Conditions are reproduced in Delaume, *Transnational Contracts: Applicable Law and Settlement of Disputes* (Oceana Publications, New York, 1988) Appendix IV, Booklet A, Release 94-1.

30 The ECE General Conditions have been translated into various languages and more than one million copies of them have been sold. UNCITRAL, *Yearbook* vol I, (UN, New York, 1968-1970) at 28.

31 Benjamin, "The ECE General Conditions of Sale and Standard Forms of Contract" (1961) *J Business L* 113 at 122.

cases where general conditions as a whole are undesirable, selected provisions may be incorporated into the contract. Even if the specific needs of countertrading parties are not compatible with these general conditions, they may be consulted as a guide to drafting a detailed contract.

2. Standard Countertrade Contracts

2.1. General Remarks

A contract may be drafted in a variety of ways, allocating responsibility, rights and costs differently. Equally, the legal effect given to contracts may be different in various national legal systems. In practice, particular groups of business people, or even large companies, have developed their own detailed contracts to be used in a repeated course of trade with different consumers. The need is greater for countertrade purposes because the contract has not only to specify the goods and the prices in both directions but also to cover many other matters, such as contractual relations between the purchase and the counter-purchase, a machinery for payment, and the rights and obligations of each party. The companies involved in countertrade may prefer to adopt one particular countertrade contract to be used in similar situations. The form usually contains comprehensive provisions explaining the contractual relations of the parties in detail. By adopting this method, the users not only achieve uniformity in relation to their trading partners but also avoid the difficulties caused by diversity in national legal systems.

Since standard forms have been used frequently by exporting or importing companies, it is worthwhile to examine this practice with reference to countertrade. At the outset, a comparison between standard forms and general conditions on one hand and contract of adhesion on the other hand is helpful in understanding standard forms. The impact of national or international legislation on standard forms should also be examined. The potential ways to support a weaker party to a standard countertrade contract at the national or international level is another issue to be discussed here. Finally, some precautions in using a standard countertrade contract will be suggested.

2.2. What is Meant by Standard Form Contracts?

There is no consensus in meanings given to standard forms. In 1953, H B Sales pointed out that "neither the expression 'standard form contract' nor any variant of it has acquired the status of a term of art or, indeed, any recognised and distinctive meaning".[32] In many cases the definition is left to the judiciary or arbitration to determine whether or not a standard form has been used.[33] It is to be noted that in this Chapter the term *standard form contracts* has an identical meaning to model contract forms. Thus, a standard form means a previously written document which becomes a complete contract by filling in a few blanks.[34]

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32 Sales, "Standard Form Contracts" (1953) 16 *Modern L Rev* 318 at 318.

33 The Great Britain Law Commission concluded:

> We think that the courts are well able to recognise standard terms used by persons in the course of their business, and that any attempt to lay down a precise definition of 'standard form contract' would leave open the possibility that terms that were clearly contained in a standard form might fall outside the definition. In our view this would be unfortunate. We have not, therefore, attempted to formulate a statutory description of a standard form contract.

The Great Britain Law Commission (No 69, 1975) at 61.

34 Some legislation defines standard contracts to mean: "a contract ... all or any of whose terms have been fixed in advance by, or on behalf of, the person supplying the commodity or service ... with the object of constituting conditions of many contracts between him and persons undefined as to their number or identity". Section 1 of the *Standard Contracts Law* 5724-1964 (Israel); its English translation has been appended to Lando, "Standard Contracts, a Proposal and a Perspective" (1966) *Scandinavian Studies in Law* 129 at 144ff.

In other words, a standard form is composed of a set of fixed terms and some blanks to be completed which can be used in contracts of that kind without essential variation.[35] Although the blanks to be filled in vary from transaction to transaction, they are often designated for the names of the parties, the date, the quality and quantity of products and the like.

For a better understanding, standard forms should be distinguished from related expressions such as *standard terms*, *general conditions*, and *contract of adhesion*, even though in the literature they have often been used interchangeably. Generally speaking, *standard terms* refers to a set of fixed terms prepared in advance to be incorporated into a contract. Although both standard forms and standard terms are similarly prepared and fixed in advance and rarely subjected to negotiation, the main difference between them lies in the fact that *standard terms* do not constitute a contract by themselves but have to be incorporated into a contract. On the other hand, standard forms are almost complete contracts, having the format of a model contract, which are ready to be filled in and to be signed. In standard forms a reference may be made to particular standard terms but not vice versa.[36] Standard forms should also be distinguished from general conditions although both

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35 For the interest of the *Unfair Contract Terms Act* 1977 (UK), in *McCrone v Boots Farm Sales* [1981] SLT 103 at 105, Lord Dunpark said that *standard form contract* "is, in my opinion, wide enough to include any contract, whether wholly written or partly oral, which includes a set of fixed terms or conditions which the proponer applies, without material variation, to contracts of the kind in question".

36 Section 2-102(a) of the US *Uniform Commercial Code Revised*, proposed by a Drafting Committee of the National Conference on Uniform States Laws, reads:

> (37) 'Standard from' means a record prepared by one party in advance for general and repeated use that substantially contains standard terms and was used in the transaction without negotiation of, or changes in, the substantial majority of the standard terms. Negotiation of price, quantity, time of delivery or method of payment does not preclude a record from being a standard form.
>
> (38) 'Standard terms' means terms prepared in advance for general and repeated use by one party and used without negotiations with the other party.

A copy of the revised section has been appended to Weiskopf, "Standard Forms and Standard Terms: Revising Article 2 of the UCC" (1996) 29 *Uniform Commercial Code L J* 257 at 286ff.

generally indicate the same notion of standardisation. While standard forms are model contracts, general conditions are a set of rules which provides a legal regime within which a contract is to be construed and effectuated.

Although *standard forms* and *contracts of adhesion* are used interchangeably,[37] it is also helpful to see whether or not they are identical. A contract of adhesion is a "standardised contract which imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it".[38] In *Golz v Children's Bureau of New Orleans*, a contract of adhesion was broadly defined as "a standard contract, usually in printed form, prepared by a party of superior bargaining power for adherence or rejection of the weaker party".[39] The purchase of a ticket from a monopolist transportation company represents the notion of adherence very clearly. The company has a monopoly or semi-monopoly power and the passenger has to buy the ticket. While the contract rests on a take-it-or-leave-it basis, the weaker party often has to take it. The concept of adherence implies that the superior party, taking advantage of its strong position, has drafted the standard form unfairly for its own interest.

The notion of standard forms in commercial relations, especially at the international level differs, at least to some extent, from adhesion contracts at the national level. The difference was highlighted in the words of Lord Diplock in *Macaulay v Schroeder Music Publishing*:

> Standard forms of contracts are of two kinds. The first, of very ancient origin, are those which set out the terms upon which mercantile transactions of common occurrence are to be carried out. Examples are bills of lading, charterparties, policies of insurance, contracts of sale in the commodity markets. The standard clauses in these contracts have been settled over the years by negotiation by

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37 Rakoff, "Contracts of Adhesion: An Essay in Reconstruction" (1983) 96(2) *Harvard L Rev* 1174 at 1177.

38 *Neal v State Farm* 188 Cal App 2d 690 (1961) at 694; see also Kessler, "Contracts of Adhesion - Some Thoughts about Freedom of Contract" (1943) 43 *Columbia L Rev* 629 at 631ff.

39 326 So 2d 865 (1976) at 869; see also Hersbergen, "Contracts of Adhesion Under the Louisiana Civil Code" (1982) 43 *Louisiana L Rev* 1 at 1.

> representatives of the commercial interests involved and have been widely adopted because experience has shown that they facilitate the conduct of trade. Contracts of these kinds affect not only the actual parties to them but also others who may have a commercial interest in the transactions to which they relate, as buyers or sellers, charterers or shipowners, insurers or bankers. If fairness or reasonableness were relevant to their enforceability the fact that they are widely used by parties whose bargaining power is fairly matched would raise a strong presumption that their terms are fair and reasonable.
> The same presumption, however, does not apply to the other kind of standard form of contract. This is of comparatively modern origin. It is the result of the concentration of particular kinds of business in relatively few hands. The ticket cases in the 19th century provide what are probably the first examples. The terms of this kind of standard form of contract have not been the subject of negotiation between the parties to it, or approved by any organisation representing the interests of the weaker party. They have been dictated by that party whose bargaining power either exercised alone or in conjunction with others providing similar goods or services, enables him to say: 'If you want these goods or services at all, these are the only terms on which they are obtainable. Take it or leave it.'[40]

As a result, contracts of adhesion represent the domestic notion of standardisation where a party with strong bargaining power uses standard forms in relation to a weaker party who needs the goods or services and is not in a position to look for a better deal because of monopoly or semi-monopoly position of the strong party. Since in commercial relations, especially at the international level, *standard forms* refers to pre-prepared model contracts drafted to be used for repeated deals, the term *standard forms* is preferred to *contracts of adhesion*.[41]

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40 [1974] 1 WLR 1308 at 1316.

41 The distinction between these two kinds of standard forms had been drawn by some scholars even before *Macaulay*. See Kessler, "Contracts of Adhesion - Some Thoughts about Freedom of Contract" (1943) 43 *Columbia L Rev* 629 at 631-632; Sales, "Standard Form Contracts" (1953) 16 *Modern L R* 318 at 319; Schmitthoff, "Standard Contracts and the Protection of the Weaker Party in International Trade Relations" in UNIDROIT, *New Directions in International Trade Law* vol 1 (UNIDROIT, New York, 1977) at 177.

2.3. Standard Forms for Countertrade Contracts

Countertraders have developed standard forms to be used in similar circumstances. The large companies prefer to draft their own standard forms to be used with or without any amendments. Small and medium size firms, on the other hand, often prefer to use those model contracts drafted previously by larger firms or by internal or international agencies, perhaps with some minor variations. It might be unnecessary or even out of the capability of these firms to establish and run a research team in order to tailor a comprehensive model countertrade contract. Most businesses show more interest in adopting standard forms prepared by some professional organisations or international bodies. For example, international trade associations, organisations affiliated to the UN and government departments have developed certain standard countertrade contracts for general interest.

The United Nations Economic Commission for Europe, commonly known as the ECE, has sponsored a number of standard forms in various trade fields.[42] The ECE has published two Guides in respect of counterpurchase and buy-back arrangements. These two Guides, *International Counterpurchase Contracts*[43] and *International Buy-back Contracts*[44], were drafted by the Working Party on International Contract Practices in Industry and approved at the thirty-fifth session (November 1989) and the thirty-sixth session (June 1990) respectively. Each Guide consists of two separated but linked parts. The first part provides a basis for understanding the nature of the transaction, the necessary elements to be

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42 There is a legal organ within the ECE which is to simplify and standardise export documents. For example, Form 574A is for the *Supply and Erection of Machinery for Import and Export* and Form 574B is related to *Listing Additional Clauses for Supervision of Erection of Engineering Plant and Machinery Abroad.* Schmitthoff, *Schmitthoff's Export Trade* (Stevens, London 9th ed 1990) at 73-74

43 ECE, *International Counterpurchase Contracts* (UN, New York, 1990).

44 ECE, *International Buy-Back Contract* (UN, New York, 1991).

included in the contract, and how to shape the contractual relationship between the parities. The second part is a model contract drafted in accordance with the elements highlighted in the first part. Although the model contract is in the format of a complete counterpurchase or buy-back contract, there are certain options in the text which make the model contract more flexible to tailor to different needs.

Similarly, the International Association of State Trading Organisations of Developing Countries (ASTRO) has included a sample countertrade contract in its Manual of Comprehensive Reference Service on Countertrade.[45] This sample is only a standard form for counterpurchase. It is a simple standard form which covers only the most important issues of counterpurchase, having left many details unmentioned.

In some cases a government agency sponsors drafting a countertrade model contract to be used by State trading organisations in particular or for general use. For example, the Ministry of Trade and Industry of Malaysia has drawn up a sample counterpurchase agreement.[46] This standard form has been drawn up not only to assist Malaysian companies to engage in counterpurchase practices more efficiently but also to include certain provisions in the interest of Malaysian trading companies. For example, its Article XII provides: "This Agreement shall be governed by and interpreted in accordance with the laws of Malaysia".[47] Romania has also published a sample countertrade contract to be used by Romanian companies.[48]

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45 A copy of this countertrade sample contract can be found in Commonwealth Secretariat, *Countertrade: Guidelines for Developing Countries* (Commonwealth Secretariat, London, 1988) at 78.

46 This sample counterpurchase agreement has been re-produced in Rubin, *The Business Manager's: Guide to Barter, Offset and Countertrade* (The Economist Intelligence Unit, London, 1986) 97.

47 At 101.

48 At 108.

In some countries, standard countertrade forms have been set up on a take-it-or-leave-it basis which it is unlikely to be open to negotiation. They have been prepared and fixed in advance by a government department in such a way that a trading partner has to sign them as they are or leave the deal. The Indonesian policy is an outstanding example of adopting such a procedure. All firms making a tender for government procurement have to sign a standard form undertaking a counter-purchase pursuant to stipulations set out in that form. Under a Letter of Undertaking published by Department of Trade and Cooperatives, Republic of Indonesia, every firm making a tender undertakes to observe the following:

> If we are selected as (contractor) (supplier) in respect of the above-described tender, we hereby irrevocably undertake during the period from the date of award of the contract relating to such tender until final acceptance (or equivalent) of our work and services thereunder:
> 1. To purchase, or to cause to be purchased by one or more of our affiliated companies in (insert name of country and nationality of contractor/ supplier) or by third parties located in such country acceptable to you, agricultural and/ or industrial products contained in the most recent 'List of Indonesian Export Commodities Available for Additional Export' published by the Department of Trade and Cooperative (hereinafter the 'Products') from one or more of the commodity associations or exporters named in the 'List of Indonesian Commodity Associations and Exporters' published by the Department of Trade and Cooperatives (hereinafter the 'Exporters' in an amount at least equal to the foreign currency value of all the equipment and materials to be supplied by us from non-Indonesian sources pursuant to the terms of the above-described contract; ...
> If we fail to comply with our undertaking contained herein, we hereby agree to pay to you as liquidated damages an amount equal to 50% of the difference between the total value of products actually purchased pursuant to this undertaking and the total foreign currency value of all equipment and materials actually supplied by us from non-Indonesian sources pursuant to the terms of the contract awarded in respect of the above-described tender.[49]

Although such a rigidity in non-negotiability of contents of a standard form is supposed to be rare in today's international trade, it may come from the strong bargaining strength of a party or be mandated by government.

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49 This Letter of Undertaking has been re-produced in Verzariu, *Countertrade, Barter and Offsets* (McGraw-Hill, New York, 1985) at 188-89.

2.4. Advantages of Using Standard Countertrade Forms

While the recent expansion of countertrade practices in different areas of business has pushed many exporting firms to get involved in countertrade programs, they have little knowledge and experience in dealing with these complicated transactions. They may need to use the knowledge of those companies having experience in countertrade practices. One way of gaining such knowledge and experience is to use standard forms drafted in advance by individual firms, professional groups or international agencies. Standard forms drawn up by international agencies are the result of a great deal of research and experience in such trade. These forms represent the current usage which exists among business people in that particular trade.[50] They are particularly useful for enterprises in the developing countries which have little capacity to draft their own countertrade contracts. Since these standard forms have generally been drafted professionally, their use enables a firm to address safely the most important contractual aspects of a countertrade contract.

The flexibility of standard forms is another positive point in using them for countertrade practices. They may easily be amended or adjusted to the needs of trading parties. Tailoring a standard form to the parties' needs is much easier than drafting a totally new one.[51] In particular, those standard forms drawn up by international agencies have been intended to maintain a level of flexibility to be used by a greater number of trading parties with different economic positions and diverse needs. As a result, a trading party may set up

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50 Schmitthoff, "Standard Contracts and the Protection of the Weaker Party in International Trade Relations" in UNIDROIT, *New Directions in International Trade Law* vol 1 (UNIDROIT, New York, 1977) at 182.

51 At 183.

its own countertrade contract upon the format and provisions set forth in a standard contract drafted previously.

Moreover, many national legal systems are not sufficiently well developed to deal efficiently with reciprocal transactions emerging somewhere and spreading suddenly around the world. Solving countertrade problems in accordance with general rules or with the rules dominated by conventional contracts does not always bring about satisfactory consequences for the countertrading parties. In addition, even a well drafted code will not be able to predict all contingencies.[52] In a standard countertrade agreement, the rights and obligations of the parties have often been specified in detail to leave little to be decided by national laws.[53] As a result, standard forms of countertrade are self-regulatory devices protecting the parties against national legal diversity and disparity.

The use of standard forms in similar circumstances also reduces the overall cost of the transaction.[54] Drafting individual countertrade contracts for each case requires the establishment of a legal unit within the firm or the services of a legal firm of extra cost. Completing, amending or adjusting printed forms is also easier for administrators than drafting a total countertrade contract through negotiating term by term. As a matter of convenience, the use of standard forms is also significant for the user because there is a tendency for human beings to follow precedent.[55] Moreover, the use of standard forms represents a non-discriminatory view of the firm towards its different trading partners which

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52 Deutch, *Unfair Contract: the Doctrine of Unconscionability* (Lexington Books, Toronto, Canada, 1977) at 7.

53 Michida, "Possible Avenues to Preparation of Standard Contracts for International Trade on a Global Level" in Honnold (ed), *Unification of the Law Governing International Sales of Goods* (Librairie Dalloz, Paris, 1966) at 254.

54 Trebilcock, "The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords" (1976) 26 *University of Toronto L J* 359 at 364.

55 Adams, "The Standardisation of Commercial Contracts, or the Contractualisation of Standard Forms" (1978) 7 *Anglo-American L Rev* 136 at 138.

improves the image of the user. It should be noted that new technological developments in the telecommunications industry accelerates the use of standard forms. Through a modem, contracting parties make the transaction by feeding in electronic impulses rather than inserting blanks in printed forms. The use of the computer as a means of making a contract will be accompanied by a widespread use of standard forms in their computerised versions.[56] Finally, the use of standard forms gives an opportunity to the parties to concentrate their negotiations on particular issues such as the kind of goods, quality, quantity, price, time of delivery and the like. When the agreement is reached on these issues, the parties need only fill in the standard form, leaving other issues unchanged.

2.5. National Laws and Standard Countertrade Contracts

The legitimacy of standard forms is based on the principle of party autonomy in regulating their contractual relationship by selecting the form of the contract, its contents and the applicable law. This principle has been adopted, more or less, in almost all national laws authorising contracting parties, particularly at an international level, to decide about the parties' rights and obligations. The autonomy of traders in making a transaction and shaping its contents similarly applies to cases where they use a standard contract prepared in advance. It makes no difference to the general principle involved whether contracting parties enter into a contract by negotiating term by term or by filling in a printed standard agreement prepared previously, because in both cases parties have reached the agreement through their will.

56 Allan & Hiscock, *Law of Contract in Australia* (CCH, Sydney, 2nd ed 1992) para 304.

Since standard contracts, like other agreements, are to be effective by reference to a national legal system, the mandatory rules of that legal system should be considered in drafting them. Different legal systems may have their own mandatory rules with which the parties must agree. The violation of mandatory rules may make a contract unenforceable, in part or in whole, in a particular jurisdiction. There may be mandatory rules specific to standard contracts in order to protect the weaker party against unfair terms included by the stronger party either to limit its liability or to impose greater responsibilities on the weaker party.[57] The use of standard countertrade contracts raises two questions: first, whether there is actually a weaker party to be protected; and secondly, whether the protective rules, which are in force in many national laws, apply equally to standard countertrade forms or whether they are exclusive to consumer transactions.

2.5.1. A Weaker Party to Countertrade?

The existence of weaker parties in countertrade practices is not difficult to ascertain. A demand for countertrade often implies a shortage of hard currency, poor quality products to be disposed of, insufficient knowledge of marketing, the need for advanced technology or the like. In addition, most countertrade requests have been made by developing countries with little economic strength. On the other hand, the firms who positively respond to countertrade often belong to multi-national enterprises or large companies with considerable economic superiority and may even dominate a particular industry or marketplace. The relationship between a producer in a poor developing country and a Western multi-national firm may well be a relationship between a strong and a weaker party. It should, however,

57 Schmitthoff, "Standard Contracts and the Protection of the Weaker Party in International Trade Relations" in UNIDROIT, *New Directions in International Trade Law* vol 1 (UNIDROIT, New York, 1977) at 178.

be noted on the other hand that a strong party may be a government agency demanding countertrade as a countertrade policy. To access markets in these countries, companies need to respond positively to countertrade demands, otherwise they will be excluded from a deal or even from the market. These government agencies take advantage of their strength to impose countertrade requirements on companies for whom such a market or deal is vital.

As a result, the existence of significantly weaker parties is a fact in the international countertrade environment. The strong party may take advantage of its economic superiority by using pre-prepared standard forms which spell out in detail the contractual relationship of the parties. These standard forms, which may be prepared by the strong party for its own interest, generally provide no opportunity to the other party to negotiate its contents. Thus, the weaker party has either to accept the contract as it is or leave it entirely. The last question is whether a greater bargaining strength in international trade creates a situation justifying the intervention of the judiciary to protect the weaker party, as it intervenes to protect consumers in the domestic context.

2.5.2. The Application of Protective Rule to Standard Countertrade

Since there is no broad convention or established custom dealing with international standard contracts incorporating oppressive terms,[58] a reference should be made to national laws to

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58 Although Article 86 of the EEC Treaty prohibits any abuse of rights by the party in a dominant position, it applies to the parties usually of uniform economic power in Europe. Article 86 reads:

> Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in:
> (a) directly or indirectly imposing unfair purchase or selling prices or unfair trading conditions;
> (b) limiting production, markets or technical development to the prejudice of consumers;
> (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

examine whether there is some legal basis to protect a weaker party to an international standard form. There are at least two general possibilities supporting the weaker party. First, including unfair terms in a standard form may be considered to be contrary to the public policy of the forum. In that case, the contract becomes unenforceable in whole or in part. The difficulty with this theory is that such exploitation is not perceived as conflicting with public policy in many Western countries, except to the extent that it constitutes fraud.[59] As a result, resort to public policy to establish a basis for supporting weaker parties in international trade is uncertain.

The second way is to refer to the governing law of the contract to see whether there are mandatory rules protecting a weaker party. Although many legal systems have mandatory rules protecting weaker parties, they are hard to apply to standard countertrade forms. These rules are generally applicable to adhesion contracts which differ from those used for commercial purposes, particularly in international relations. In contracts of adhesion individual enterprises or a group of enterprises, often possessing a monopolistic position, use standard forms drafted in such a way as to safeguard the position of the user through inserting exemption clauses whereby the user limits its liabilities. The main distinguishing element of adhesion contracts is that the party with economic strength exploits consumers who are in need of the goods or services and have little chance to find a better bargain because either there is no other supplier or others use also the same clauses. Many countries have adopted certain mechanisms to protect vulnerable customers by interfering in the standard contracts drafted and used by suppliers of goods and services.

(d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

59 Eorsi, "Contracts of Adhesion and the Protection of the Weaker Party in International Trade Relations" in UNIDROIT, *New Directions in International Trade Law* vol 1 (UNIDROIT, New York, 1977) at 155.

A standard contract used for commercial purposes, particularly in international business, differs from adhesion contracts in two respects. First the bargaining power of the contracting parties is not so out of balance as is the case in adhesion contracts. The bargaining power of commercial entities is in a reasonable balance or there is enough competition in a particular business. In international business, monopolies are rare. Although a weaker party could also be found in commercial relations, the weaker party is not in need of the goods or services as is the case for consumers. Secondly, many standard forms used in international business have been drafted by international agencies reflecting the usage existing in a particular business which do not aim at exempting stronger parties from liabilities or placing additional obligations upon weaker ones. On the contrary, one of their purposes is to achieve a balance between the weaker and stronger party in that particular business. Although it can also be argued that contracts of adhesion are not contracts at all because they lack a matching of two separate wills,[60] establishing a similar basis for standard forms used for commercial deals is quite difficult.

For these reasons, in some legal systems the protectionist measures are expressly restricted to internal contracts or consumer purposes. For example, s51AB of the *Trade Practices Act* 1974 (Cth) the *Contract Review Act* 1980 (NSW),[61] and the *Standard Contracts Law* 5724-1964 (Israel) which provide certain protections in favour of weaker parties have confined themselves to consumer cases. In *Madden v Kaiser Foundation Hospitals*, the California Supreme Court identified two elements for adhesion contracts: first, the stronger party has drafted the contract without giving an opportunity to the weaker party to

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60 Schmitthoff, "Standard Contracts and the Protection of the Weaker Party in International Trade Relations" in UNIDROIT, *New Directions in International Trade Law* vol 1 (UNIDROIT, New York, 1977) at 179; Rakoff, "Contracts of Adhesion: An Essay in Reconstruction" (1983) 96(2) *Harvard L Rev* 1174 at 1229.

61 Section 6(2) of the *Contract Review Act* 1980 (NSW).

negotiate its content; and second, the weaker party has no opportunity to find a better deal and must accept the standard contract or miss the service which is needed.[62] As a result, since finding these two characteristics in commercial contracts is very unlikely, the theory of adhesion is limited to consumer-type agreements.[63]

In the *Dutch Civil Code*, which came into force on 1 January 1992, measures for protecting weaker parties apply to both consumers and small companies but not large ones.[64] Although the *Supply of Goods (Implied Terms) Act* 1973 (UK)[65] and the *Unfair Contract Terms Act* 1977 (UK), which control unreasonable exemption clauses in standard contracts, apply equally to consumer and commercial cases, their application is restricted to domestic contracts.[66] This Act does not apply to the international sale or supply of goods.[67] Law Commission pointed out three reasons for this exclusion.[68] First, when goods are to be exported from a country, it is for the legal system of the country of destination to specify its own controlling measures. Second, since international trade involves large transactions, the parties wish to be free to negotiate their own terms. Third, the application of the Act to international transactions exposes English exporters to restrictions which would not apply to their foreign competitors. In sum, it is difficult to establish a legal basis to interfere in standard countertrade contracts to protect the weaker party because the theory of adhesion is not easily applicable to commercial deals at an international level. Moreover, in many

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62 17 Cal 3d 699 (1976) at 711.

63 Kim, "Graham v Scissor-Tail, Inc: Unconscionability of Presumptively Biased Arbitration Clauses Within Adhesion Contracts" (1982) 70 *California L Rev* 1014 at 1018.

64 "[A] small company is defined as a company that employs less than 50 employees and whose asset value is less than Dfl 4 million or whose net turnover is less that Dfl 8 million per annum." Sperling, "Standard Conditions under Dutch Law" (1993) *International Business Lawyer* 488 at 489.

65 Hall, "International Sales and the Supply of Goods (Implied Terms) Act 1973" (1973) 22 *International & Comparative L Q* 740 at 741.

66 Section 17 of the *Unfair Contract Terms Act* 1977 (UK).

67 Section 26 of the *Unfair Contract Terms Act* 1977 (UK); Thompson, *Unfair Contract Terms Act 1977* (Butterworths, London, 1978) at 34.

68 *The Great Britain Law Commission* (No 24, 1969) at 46.

jurisdictions such supporting measures are expressly restricted to consumer cases, or extended only to small companies or internal commercial deals. Here it is worthwhile to see whether standard countertrade contracts enjoy any support in the Australian legal system if the terms are oppressive or unfair.

2.6. Standard Countertrade Forms and Australian Law

Since the validity of standard forms is based on the principle of party autonomy, courts in Australia honour these types of contracts in so far as they are not contrary to public policy or mandatory rules of the forum. When terms of standard countertrade contracts are unfair or oppressive, does Australian law protect the weaker party? Broadly speaking, certain methods have been developed in Australia to deal with the issue of inequality in bargaining power of the contracting parties. The first method ascertains procuring and maintaining competition in trade. Under s45 of the *Trade Practices Act* 1974 (Cth), a corporation must not make a contract, arrangement or understanding which contains exclusionary provisions or a provision of the proposed contract, arrangement or understanding with the purpose of, or the likely effect of substantially lessening competition. A contract in restraint of trade[69] not only is unenforceable[70] but also may result in imposition of a penalty of up to $10 million for corporations and $500,000 for individuals.[71] Moreover, a guilty party must compensate for any damage or loss caused to third parties.[72] The aim of these rules is to

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69 In *Petrofina (Great Britain) v Martin* [1966] Ch 146 at 180, Diplock J said:

> A contract in restraint of trade is one in which a party (the covenantor) agrees with any party (the covenantee) to restrict his liberty in the future to carry on trade with other parties not parties to the contract in such manner as he chooses.

70 *Buckley v Tutty* (1971) 125 CLR 353 at 376; *Amoco Australia v Rocca Bros Motor Engineering* (1973) 133 CLR 288 at 306; *Bridge v Deacons* [1984] AC 705 at 713.

71 Section 76 of the *Trade Practices Act* 1974 (Cth).

72 Section 82 of the *Trade Practices Act* 1974 (Cth).

control anti-competitive conduct resulting in lessening competition and creating monopolisation.

Secondly, if the use of standard forms constitutes a case of fraud, duress, undue influence or misrepresentation, a ground for relief may be established under general law of contract or particular legislation. Section 52(1) of the *Trade Practices Act* 1974 (Cth), for example, provides: "A corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive."[73] Although this section is within "Part V, Consumer Protection", it has a broad application.[74] Since these rules apply equally to standard countertrade contracts, courts may grant relief if using such standard contracts creates a case of fraud, misleading or deception.

The third method is to set aside certain terms of standard forms based on inequality of bargaining power as a ground distinct from fraud. Accordingly, when inequality of bargaining power results in the conclusion of an unconscionable contract, relief may be granted. In *Commercial Bank of Australia v Amadio*, Mason J said:

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73 Since there are some restrictions on Commonwealth legislative power, individual *Fair Trading Acts* have come into effect in different States and Territories. As regards s51A, corresponding sections in State legislation are: *Fair Trading Act* 1987 (NSW) s41; *Fair Trading Act* 1989 (Qld) s37; *Fair Trading Act* 1987 (SA) s54; *Fair Trading Act* 1990 (Tas) s11; *Fair Trading Act* 1985 (Vic) s10a; *Fair Trading Act* 1987 (WA) s9; *Fair Trading Act* 1992 (ACT) s11; and *Consumer Affairs and Fair Trading Act* 1990 (NT) s 41.

74 In *Hornsby Building Information Centre v Sydney Building Information Centre* (1978) 140 CLR 216 at 223, Stephen J said:

> Section 52(1) of the [Trade Practices] Act is expressed in wide terms and its generality is expressly preserved by sub-s. (2). Its operation requires the existence of three factors, a 'corporation', its engagement in conduct answering the description of 'misleading or deceptive' and the occurrence of that conduct 'in trade or commerce'. If each of those factors be present a contravention of s. 52 will occur.

See also *Bevanere v Lubidineuse* (1985) 59 ALR 334. In *Concrete Constructions v Nelson* (1990) 169 CLR 594 at 601, the majority said:

> As a matter of language, s.52 prohibits a corporation from engaging in misleading or deceptive conduct 'in trade or commerce' regardless of whether the conduct is misleading to, or deceptive of, a person in the capacity of a consumer. In these circumstances, it is not permissible to give to the heading of Pt V the effect of confining the general words of s.52 to cases involving the protection of consumers alone.

> Relief on the ground of unconscionable conduct will be granted when unconscientious advantage is taken of an innocent party whose will is overborne so that it is not independent and voluntary, just as it will be granted when such advantage is taken of an innocent party who, though not deprived of an independent and voluntary will, is unable to make a worthwhile judgment as to what is in his best interest.[75]

Since the doctrine of unconscionability has been developed in the consumer environment, a question arises whether inequality of bargaining power is also considered a ground for granting relief in commercial contracts, particularly in international relations. The essential role of the court's equitable jurisdiction is to hear and to apply equal rules to all similar cases including international cases. However, in *Commercial Bank of Australia v Amadio*,[76] Deane J said that the jurisdiction of courts of equity to relieve against unconscionable dealings has long being established as extending generally to circumstances in which a) the weaker party is under a special disability, b) the stronger must have been aware of that disability, and c) an unfair contract has been signed. These required criteria are hardly applicable to countertrade deals, because disabilities include poverty, sickness, age, drunkenness, illiteracy,[77] and the like which can hardly be found in international countertrade deals.

The reasons that courts are reluctant to apply the doctrine to commercial transactions could be several. At the outset, as Lord Diplock has demonstrated in *Macaulay*, standard forms in commercial transactions differ from those used for consumer purposes.[78] Many standard forms used in commerce are drawn by both contracting parties or by their representative under the auspices of specialised agencies. They achieve a balance of conflicting interests and provide a fair allocation of risks between the parties.

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75 (1983) 151 CLR 447 at 461.
76 (1983) 151 CLR 447 at 474.
77 *Blomley v Ryan* (1956) 99 CLR 362 at 405.
78 *Macaulay v Schroeder Music Publishing* [1974] 1 WLR 1308 at 1316.

Secondly, business people are fully capable of protecting themselves.[79] They normally have sufficient access to legal consultants or other advisers to be aware of the consequences of a standard form. Although a case of inequality in bargaining power may exist, a case of unconscionability or abuse of power is unlikely.[80] As mentioned in the Law Commission Report, apart from a very small number of cases where farmers have bought agricultural machinery and where the supply of specialised equipment to local authorities is involved, "the evidence collected by the Working Party disclosed no strong demand for restraining the present freedom to contract out of the statutory conditions and Warranties. In fact, a number of memoranda expressed considerable opposition to any interference with the freedom of contract in the non-consumer area".[81]

Thirdly, it is vital for commercial transactions to be established with certainty. Interference in contractual freedom damages predicability of the contract. This is highly undesirable for business people. Assurance and predicability gives businesses the opportunity to plan their future business effectively. They make an offer or accept an offer based on the contracts they have made or they are making. Any interference in commercial transactions may affect the marketing process adversely. The reluctance to interfere in commercial contracts is well stated in the words of Lord Scarman in *National Westminster Bank v Morgan* that:

> even in the field of contract I question whether there is any need in the modern law to erect a general principle of relief against inequality of bargaining power. Parliament has undertaken the task - and it is essentially a legislative task - of enacting such restrictions upon freedom of contract as are in its judgment necessary to relieve against the mischief. ... I doubt whether the courts should assume the burden of formulating further restrictions."[82]

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79 Livermore, *Exclusion Clauses and Implied Obligations in Contracts for the Supply of Goods and Services* (Law Report Commission of Tasmania, 1980) at 66.

80 Peden, *The Law of Unjust Contracts* (Butterworths, Sydney, 1982) at 85.

81 *The Great Britain Law Commission,* (No 24, 1969) at 35-36.

82 [1985] 1 AC 686 at 708.

Moreover, any interference in commercial transactions may result in further inequity between the parties.[83] Professor Peden, in a report to Minister for Consumer Affairs, New South Wales pointed out:

> There are many instances where large corporations, well-situated to obtain legal advice, freely enter a contract which, because of prevailing market conditions is particularly advantageous to one and equally harsh on the other. Alternatively one party may be willing to accept a particularly oppressive clause in a contract because it is obtaining a bargain in another respect such as a very competitive price. It is important that such contracts should not be invalidated or rendered uncertain merely because of a temporary inequality of bargaining power except on proof of additional facts which are recognised grounds of avoidance such as fraud. To provide otherwise would introduce a most undesirable element of uncertainty into many perfectly legitimate commercial dealings.[84]

The above arguments may well not apply to small business enterprises. The necessity of extending protective measures to small businesses stems from the fact that they are in no better position compared to consumers when they trade with large and multi-national companies. They often lack the sophistication needed to confront the companies dominating a particular market. For these reasons, some national laws have extended the supporting measures to cover small businesses.[85]

A question, however, arises over where to draw the line between small businesses, which need protection, and large ones, which do not. Since finding a workable definition of small business was difficult, the protections set out in the *Contracts Review Act* 1980 (NSW) have not extended to small businesses.[86] Accordingly, those cases under which a person entering into a contract in the course of or for the purpose of a trade, business or profession

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83 Livermore, *Exclusion Clauses and Implied Obligations in Contracts for the Supply of Goods and Services* (Law Report Commission of Tasmania, 1980) at 67.

84 Peden, *Harsh and Unconscionable Contracts* (Report to the Minister for Consumer Affairs and Co-Operative Societies and the Attorney General, for New South Wales, 1976) at 16-17.

85 For example Dutch Civil Code. See Sperling, "Standard Conditions under Dutch Law" (1993) *International Business Lawyer* 488 at 489.

86 Peden, *The Law of Unjust Contracts* (Butterworths, Sydney, 1982) at 115.

are excluded from the scope of the Act, irrespective of whether they are entered into by small or large businesses.[87] As a result, the scope of the Act is mainly limited to consumer cases.[88] Similarly, s51AB of *Trade Practices Act* 1974 (Cth) prohibiting corporations to engage in unconscionable conduct has been limited to consumer cases. Under s51AB(6), the section does not apply to the supply of goods for the purpose of re-supply or for the purpose of using them up or transforming them in trade or commerce. As a result, the statutory control of unconscionable conduct set out in s51AB of the *Trade Practices Act* 1974 (Cth) does not cover countertrade contracts.

In sum, neither State nor Federal legislation has provided much in the way of protecting a weaker party if the standard countertrade contract contains excessively unfair terms in the stronger party's interests. If a trading party engages in misleading or deceptive conduct through using a standard countertrade contract, the conduct is prohibited by s52 of the *Trade Practices Act.*[89] In addition, s51AA(1) of the Act provides that a "corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories".[90] Thus, if in accordance with the common law or equity conduct is perceived as unconscionable, a remedy exists and corporations must not engage in it. In fact, the common law provides no real remedy in unconscionable contracts.[91] It is also unlikely that an Australian court would

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87 Section 6(2) of the *Contract Review Act* 1980 (NSW).

88 It is to be noted that the only exemption to the above rule is "a farming undertaking ... carried on by him or proposed to be carried on by him wholly or principally in New South Wales". Section 6(2) of the *Contract Review Act* 1980 (NSW).

89 For a general discussion of s52AA see Marshall, "Liability for Unconscionable and Misleading Conduct in Commercial Dealings: Balancing Commercial Morality and Individual Responsibility" (1995) 7 *Bond L Rev* 42.

90 It is said that the term *unwritten law* refers to the equitable concept of unconscionable conduct. Zumbo, "The Doctrine of Unconscionability: An enigma?" (1995) 3(1) *Current Commercial L* 5 at 9.

91 Graw, *An Introduction to the Law of Contract* (The Law Book Co, NSW, 1993) at 262.

extend the doctrine of unconscionability to international standard countertrade forms on the basis of inequality in bargaining strength. Moreover, courts may be reluctant to interfere with the contractual freedom beyond what legislation has allowed. However, if the use of a standard countertrade form leads to a case of fraud, relief may be granted on the basis of fraud.

2.7. Precautions in Using Standard Countertrade Forms

Since it is widely perceived that courts should not interfere in international contracts, filling in a standard form has generally the same effect as a contract which is drafted term by term. The parties should bear in mind that a standard contract presented by a trading party may provide a greater advantage to its supplier. Even in cases where the standard form has been drafted by trade associations or agencies, they may be prepared in the interest of their members and in the absence of a balance between the conflicting interests of both sides.[92] The following elements should be taken into account when a trading party is confronted with a standard form.

i) Since trading partners to whom standard forms are presented have not participated in their drafting, they ought to look at each provision with great caution. The user is biased towards its own interest and against the other party's interest. Ambiguous terms may have been inserted deliberately to support the user in case of any disputes arising.

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92 Eorsi wrote: "In Western economic life this would of course be an irregular, exceptional phenomenon. It would be naive to expect, for example, that the stronger party would of his own will submit himself to contractual terms conceived impartially, and so refrain from exploiting his economic superiority." Eorsi, "Contracts of Adhesion and the Protection of the Weaker Party in International Trade Relations" in UNIDROIT, *New Directions in International Trade Law* vol 1 (UNIDROIT, New York, 1977) at 164.

ii) Within the standard form, a reference may be made to some general conditions, a particular practice, a set of rules or the like of which the other party is not aware. Such a reference may have a great impact on the rights and obligations of the parties. It is wise to scrutinise carefully any term which may imply such a reference to avoid unexpected consequences.[93] If there is a reference to a set of rules, they should be read prior to making the deal. The situation becomes worse if the rules referred to are in a language other than that of the standard form of negotiations.[94] Another difficulty in such references is that the terms of the standard form may be incompatible with the rules referred to. Any incompatibility needs to be worked out in some way before concluding the transaction.

iii) Since the standard forms are drafted in advance, they may not be well fitted for the current situation. A rush into signing a standard countertrade contract may result in unexpected consequences, even if that particular form has been used previously. Sufficient attention must be paid to terms of the standard agreement to ascertain their compatibility with the current circumstances.

3. Using Standard Terms in Countertrade Contracts

The purpose of this section is to provide a brief explanation of using standard terms in countertrade contracts. *Standard terms* refers to cases where a partial standardisation with respect to certain aspects of the contract has been achieved. In this method, the parties make their own contract, incorporating into it some typical and standard terms prepared in

93 At 167.

94 Sarcevic, "Standard Forms and General Conditions" in Voskuil & Wade (ed), *Hague-Zagreb Essays 4, on the Law of International Trade* (TMC Asser Instituut, the Hague, 1983) at 144.

advance for general use. The parties seek to give particular meanings to certain terms of the contract avoiding diverse interpretations. Although both *standard terms* and *general conditions* are used for the standardisation of contracts, a distinction could be drawn between them.[95] *Standard terms* generally refers to a set of terms, definitions or the like fixed in advance for later reference for a partial standardisation in respect of certain aspects of the contract. INCOTERMS are an outstanding example of standard terms according to which specific commercial terms, such as FOB, CIF and so on, have been defined. On the other hand, *general conditions* refer to a set of rules within which a contract has to be construed and effective.[96]

Suppose during negotiations the countertrading parties have agreed on arbitration as the sole method to settle disputes. They may simply mention that any difference or dispute arising from the contracts shall be taken to arbitration. This term leaves important details to be decided later. It may result in unexpected consequences if the parties fail to agree on details later. The parties may draft the term in greater detail in respect of numbers of arbitrators, the place and language of arbitration, the procedure, the arbitrators' power in settling disputes and the like.

For many traders involvement in these details is too complex and confusing.[97] One assured way to overcome the problem is to make reference to a particular set of arbitration rules drafted by an arbitration institution such as *Rules of the ICC Court of Arbitration, the Arbitration Rules of the United Nations Commission for International Trade Law*

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95 The Dutch Civil Code, which came into effect from 1 January 1992, defines standard conditions as "one or more written stipulations which have been drafted to be included in a number of contracts". Sperling, "Standard Conditions under Dutch Law" (1993) *International Business Lawyer* 488 at 488. This definition covers both standard terms and standard conditions alike.

96 See above, pages 217ff.

97 Fox, *International Commercial Agreements* (Kluwer, Deventer, the Netherlands, 2nd ed 1992) at 136.

(UNCITRAL), or *Arbitration Rules of the American Arbitration Association*.[98] Making reference to one of these arbitration rules is a straightforward and less expensive way of controlling the major aspects of the arbitration process, especially if the parties do not have the necessary expertise. Through this reference the provisions of the selected arbitration rules are incorporated into the contract as if they are drafted by the contracting parties themselves. Referring to these pre-prepared rules is a partial standardisation with respect to a particular aspect of the contract, viz arbitration.

In addition to the arbitration rules, arbitration institutions have also prepared an arbitration standard clause recommended to be inserted into the contract.[99] For example, the ICC recommends that all parties who wish to make reference to ICC arbitration in their contract use the following standard clause: "All disputes arising in connection with the present contract shall be finally settled under the Rules of Conciliation and Arbitration of International Chamber of Commerce by one or more arbitrators appointed in accordance with the said Rules."[100]

3.1. INCOTERMS

3.1.1. Overview

In international sales the parties often use standard abbreviations, such as FOB, CIF or EXW which determine the allocation of risks and costs between themselves. These terms,

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98 For a textual comparison of the UNCITRAL Rules with Rules of the ICC see Dore, *The UNCITRAL Framework for Arbitration in Contemporary Perspective* (Graham & Trotman, London, 1993) at 1-52.

99 Houtte, *The Law of International Trade* (Sweet & Maxwell, London, 1995) at 399.

100 This clause also has French, German, Spanish, Arabic and Japanese versions. See ICC, *ICC Rules of Conciliation and Arbitration* (ICC Publication, No 447).

however, have not always been interpreted in a same way in different countries. The contracting parties may not be aware of different obligations implied by a trade term in different legal systems. This may create misunderstandings between the parties, giving rise to disputes and litigation.[101] In 1923 the ICC published a survey of different interpretations given to six trade terms in thirteen countries.[102] This work, among others, demonstrated the need to define the trade terms.

In 1936 the ICC published the first version of *International Commercial Terms* (INCOTERMS) providing "a set of international rules for the interpretation of the most commonly used trade terms in foreign trade. Thus, the uncertainties of different interpretations of such terms in different countries can be avoided or at least reduced to a considerable degree."[103] INCOTERMS were revised or supplemented in 1953, 1967, 1976, 1980 and 1990. If the parties make a reference to a version of INCOTERMS in their contract, the trade terms, such as FOB, CIF, EXW and the like, used in the contract will be interpreted in accordance with the rules set forth in that version of INCOTERMS.

INCOTERMS are now well known in international business. In some European countries exporters stipulate in their general conditions of business that all their contracts shall be governed by INCOTERMS, unless otherwise agreed.[104] They have gained the force of law in some other countries such as Spain and Iraq.[105] With respect to practical success of the INCOTERMS 1953, the then Secretary General of the United Nations said:

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101 Schmitthoff, *Schmitthoff's Export Trade* (Stevens, London 9th ed 1990) at 63; Houtte, *The Law of International Trade* (Sweet & Maxwell, London, 1995) at 149.

102 Schmitthoff, "The Unification or Harmonisation of Law by Means of Standard Contracts and General Conditions (1969) 17 *International & Comparative L Q* 551 at 558.

103 ICC, *INCOTERMS 1990, Introduction* (ICC Publication, No 460) para 1.

104 Michida, "Possible Avenues to Preparation of Standard Contracts for International Trade on a Global Level" in Honnold (ed), *Unification of the Law Governing International Sales of Goods* (Librairie Dalloz, Paris, 1966) at 255.

105 Schmitthoff, *Schmitthoff's Export Trade* (Stevens, London, 9th ed 1990) at 66.

> The practical utilisation of Incoterms is widespread. It was reported in July 1963 that more than 100.000 copies of the English and French original had been issued: in addition, translations exist in fifteen languages. Incoterms are widely used as standard terms of business by trade associations. ... The United Nations Economic Commission for Europe embodied a reference to Incoterms, with regard to the passing of the risk in the General Conditions for the Supply of Plant and Machinery for Export, Forms Nos. 188 and 188A (1953), but substituted its own regulation for such reference in later formulations. Some foreign trade corporations of countries with centrally planned economics use Incoterms in their transactions with enterprises of countries with free enterprise economies.[106]

It is to be stressed that INCOTERMS do not purport to deal with all questions arising from a countertrade contract, but rather are limited to some aspects of the contract dealing with interpretation of certain trade terms. Since INCOTERMS are a partial standardisation, a reference to INCOTERMS may be found in general conditions or standard contracts. For example, Article 6.1 of the ECE General Conditions for the Supply of Plant and Machinery For Export, No 188 reads: "Save as provided in paragraph 7.6 the time at which the risk shall pass shall be fixed in accordance with the International Rules for the Interpretation of Trade Terms (Incoterms) of the International Chamber of Commerce in force at the date of the formation of the contract."[107] As a result, a standard countertrade contract or a contract drafted by the parties may have a reference to INCOTERMS.

In cases where particular goods are to be sent abroad as part of a countertrade program, the responsibility of each party should be made clear in respect of the following issues: i) arrangement for shipment and insurance; ii) costs of shipment, insurance, checking, packaging, marking of goods and so on; iii) damages caused in transit; and iv) obtaining export or import licences and payment of relevant duties, tax or tariffs. The parties generally use certain trade terms like FOB or CIF to determine each party's obligations on

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106 UNCITRAL, *Yearbook* vol I, (UN, New York, 1968-1970) at 37.

107 See also Article 9.1 of the *ECE General Conditions for the Supply and Erection of Plant and Machinery For Import and Export*, No 188A.

these points. The use of INCOTERMS in a countertrade contract gives an ascertained meaning to the trade terms used in the contract. Since INCOTERMS are not yet considered as international customary law, an express or implied reference to them must be incorporated into the contract.

3.1.2. INCOTERMS 1990

The latest version of INCOTERMS, known as INCOTERMS 1990,[108] has been prepared in response to the changes in means of communication and transport techniques.[109] One of the key reasons requiring the revision of the INCOTERMS 1980 was the widespread use of electronic data interchange (EDI) for commercial invoices, transport documents and particularly bills of lading. In cases where the parties agree to communicate electronically, it is significant that INCOTERMS place them in the same legal position as if they were communicating by paper. "A further reason for the revision stems from changed transportation techniques, particularly the unitisation of cargo in containers, multimodal transport and roll on-roll off traffic with road vehicles and railway wagons in 'short-sea' maritime transport."[110] In INCOTERMS 1990, trade terms have been presented in a different structure for a better understanding. The thirteen terms have been classified into four groups in accordance with their first letters: E, F, C and D terms. The E group covers only one term whereby the seller makes the goods available for the buyer at the seller's own premises (EX Work). The F group relates to the terms where the seller is expected to deliver the goods to a carrier appointed by the buyer (FCA, FAS and FOB). The C group

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108 A copy of INCOTERMS 1990 can be found in UNCITRAL, *Yearbook* vol XXII (UN, New York, 1991) at 401-434.

109 UNCITRAL, *Yearbook* vol XXIII (UN, New York, 1992) at 37.

110 ICC, *INCOTERMS 1990, Introduction* (ICC Publication, No 460) para 4.

deals with cases where the seller must contract for carriage without being liable for the risk of loss or damage to the goods or for additional costs caused by the events occurring after shipment (CFR, CIF, CPT and CIP). The group D represents cases where the seller must bear all the costs and risks needed to bring the goods to the place of destination (DAF, DES, DEQ, DDU and DDP).[111]

Previous versions of INCOTERMS have failed to receive worldwide acceptance.[112] In England exporters have used them infrequently.[113] US exporters generally refer to either the Uniform Commercial Code (UCC) or to the American Foreign Trade Definitions of 1941.[114] The UNCITRAL has refrained from making reference to INCOTERMS in both the Carriage of Goods by Sea Convention and the Vienna Sales Convention.[115] Although amendments to INCOTERMS were made and additional terms were added in 1976 and 1980, these changes were not considered enough for UNCITRAL to endorse the revision.[116] The recent version of INCOTERMS, however, has been successful in gaining the endorsement of the United Nations Commission on International Trade Law. On 12 May 1992 UNCITRAL adopted the following decision endorsing INCOTERMS 1990:

> *The United Nations Commission on International Trade Law*
>
> *Expressing its appreciation* to the International Chamber of Commerce for having transmitted to it the revised text of INCOTERMS, which was approved by the Commercial Practices Commission of the International Chamber of Commerce and entered into force on 1 July 1990, and for requesting the Commission to consider endorsing INCOTERMS 1990 for worldwide use,

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111 As above.

112 Ramberg, "INCOTERMS 1980" in Horn & Schmitthoff (ed), *The Transactional Law of International Commercial Transactions* (Kluwer, the Netherlands, 1982) at 150; Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 114 & 118.

113 Fox, *International Commercial Agreements* (Kluwer, Deventer, the Netherlands, 2nd ed 1992) at 137-138.

114 Ramberg, "INCOTERMS 1980" in Horn & Schmitthoff (ed), *The Transactional Law of International Commercial Transactions* (Kluwer, the Netherlands, 1982) at 151.

115 As above.

116 UNCITRAL, *Yearbook* vol XXII (UN, New York, 1991) at 400.

> *Congratulating* the International Chamber of Commerce on having made a further contribution to the facilitation of international trade by revising INCOTERMS to take account of changes in transportation techniques and to adapt the terms to the increasing use of electronic data interchange,
>
> *Noting* that INCOTERMS constitute a valuable contribution to the facilitation of international trade,
>
> *Commends* the use of INCOTERMS 1990 in international sales transactions.[117]

The endorsement and recommendation of UNCITRAL paves the way for further worldwide acceptance of INCOTERMS. It is likely that in the near future, they will gain the force of customary international law.

3.2. Closing Remarks

The standard terms incorporated into countertrade contracts are not limited to INCOTERMS or to arbitration rules. They include a wide range of pre-prepared terms which deal with various aspects of a contract. They may relate to the quality of goods, the price, the payment, force majeure, express or implied warranties, and so on. For instance, the United Nations International Development Organisation (UNIDO)[118] has developed certain standard model contracts for certain international activities, containing elaborated standard terms which could be used on occasion in some types of countertrade contracts.[119] For example, the UNIDO has drawn up a Model Form of Cost Reimbursable Contract for

117 UNCITRAL, *Yearbook* vol XXIII (UN, New York, 1992) at 20.

118 The UNIDO is a UN organ established on 1 January 1967. The General Assembly resolution 2152 (XXI) points out that the objective of UNIDO is to "promote industrial development, in accordance with Article I, paragraph 3, and Articles 55 and 56 of the Charter of the United Nations, and by encouraging the mobilisation of national and international resources to assist in, and with particular emphasis on the manufacturing sector." Plasil-Wenger, "UNIDO: The United Nations Industrial Development Organisation" (1971) 5(2) *J World Trade L* 188 at 189.

119 UNCITRAL, *Yearbook* vol XVII (UN, New York, 1986) at 262; Fox, *International Commercial Agreements* (Kluwer, Deventer, the Netherlands, 2nd ed 1992) at 191.

the Construction of a Fertiliser Plant and a Model Form of Turnkey Lump Sum Contract for the Construction of a Fertiliser Plant which address legal problems related to the fertiliser industry.[120]

A survey of these standard terms is, however, beyond the scope of this paper. Using appropriate standard terms helps the parties standardise certain aspects of countertrade contracts and benefit from previous experiences in drafting contractual terms.

4. Guides

Formulating standard model contracts for a particular international business activity may not be appropriate or practicable. The complexity of the deal, divergent forms, the lack of an established precedent and the variety of approaches taken by business people to drafting such transactions make it difficult to provide a model contract under which a fixed set of terms is available for drafting a transaction in different circumstances. Since in these transactions appropriate contracts have to be tailored on a case-by-case basis, it is difficult to draft a model contract. In these circumstances, something more than a standard contract is needed to cope with the needs of the parties engaging in such transactions in different parts of the world with various legal practices and conflicting interests. Thus, when the situation is too unripe to draft a uniform model contract in relation to a particular business, a text of explanatory guidance about legal aspects of the deal could be of great assistance to those engaging in that economic practice, needing to acquire information and expertise to draw up the contracts.

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120 UNCITRAL, *Yearbook* vol XII (UN, New York, 1981) at 200.

These, texts, or guides, generally discuss various issues underlying a particular transaction and make recommendations as to how to deal with difficulties which may arise from the contract. Some guides have been supported by illustrative provisions to make the issues highlighted in the main text easier to understand.[121] They also give the parties an idea of how to structure and tailor a particular term in the light of solutions discussed in the text. When providing standard forms or general conditions is impossible or impractical, the issuance of the guides paves the way to reach a standard model contract, a model law or even a convention. They have no gap-filling function or the force of law. Rather they address the general problems that arise in countertrade practices. Thus, guides can open an interesting gate for unification of international trade when providing standard forms, general conditions, a model law or a convention is far-away.[122]

Since the end of the 1970s, when a notable development occurred in the field of barter-like transactions, some studies have been undertaken in the ECE, UNCITRAL and some other organisations[123] to examine the various forms of countertrade, their legal problems and motives for engaging in such practices. Similar efforts have been made by government agencies,[124] business consultancy companies[125] and scholars.[126] The results of these studies

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121 For example, in *UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works*, some illustrative provisions are set forth in the footnotes.

122 Schmitthoff, "The Unification or Harmonisation of Law by Means of Standard Contracts and General Conditions (1969) 17 *International & Comparative L Q* 551 at 560.

123 For example, International Association of State Trading Organisations of Developing Countries (ASTRO) has published in 1986 a manual in two volumes entitled "Complementary Manual of Comprehensive Reference Service on Countertrade". The Organisation for Economic Co-operation and Development (OECD) has also published various studies, mainly on non-legal aspects of countertrade. For example, OECD, *Countertrade Practices in East/West Economic Relations* (OECD, Paris, 1979); OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981); and OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985). For more discussion about OECD works on countertrade see Chapter 10, pages 445-451.

124 For example, the US Department of Commerce, International Trade Administration has published, among others, the following booklet: Verzariu & Mitchell, *International Countertrade: Individual Country Practices* (US Department of Commerce, 1992).

125 For example, Produce Studies (PSL) which is a marketing and business consultancy company has published a study about countertrade in developing countries.

126 A list of these studies can be found in the bibliography.

provide a useful source of reference for firms with little expertise and knowledge to design and draft their countertrade contracts effectively and efficiently. The works of the ECE,[127] the Commonwealth Secretariat, and UNCITRAL in preparing guides to countertrade practices are worthy of brief mention here.

4.1. ECE Countertrade and Buy-Back Guides

In 1978, a decision was taken by the ECE Committee on the Development of Trade to invite the Secretariat to study the countertrade practices in the ECE region.[128] The study resulted in a paper entitled "Countertrade Practices in the ECE Region" which provided a description of the main practices encountered in the ECE region and the motives of firms engaged in such deals.[129] During the 1980s, the ECE Committee on the Development of Trade worked further on barter-like arrangements.[130] In November 1989, the ECE Committee prepared a booklet as a guide for International Counterpurchase Contracts. The guide focuses only on the legal problems related to the counterpurchase contract by which an exporter undertakes to counter-import some products from another. The guide discusses very briefly the issues necessary to be addressed in the contract with some recommended solutions. For a better result, a sample counterpurchase contract was appended with some alternative clauses. The clauses have been designed for illustrative purposes only and they

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127 ECE has also published certain Guides in respect of other transactions such as ECE, *Guide on Drawing up Contracts for Large Industrial Works* (UN, New York, 1973); ECE, *Guide on Drawing up International Contracts on Industrial Co-operation* (UN, New York, 1976); and ECE, *Guide for Drawing up International Contracts on Consulting Engineering, Including Some Related Aspects of Technical Assistance* (UN, New York, 1983).

128 ECE/Trade/130 para 24(i); UNCITRAL, *Yearbook* vol XII (UN, New York, 1981) at 195; UNCITRAL, *Yearbook* vol XV (UN, New York, 1984) at 325.

129 As above.

130 UNCITRAL, *Yearbook* vol XV (UN, New York, 1984) at 326.

should be adapted to the specific circumstance of a particular transaction. The guide and its appendix are a primary source in identifying the key issues of a counterpurchase agreement which are useful for business people engaged in counterpurchase arrangements.

Six months later (June 1990) a similar pamphlet was published by the ECE Committee on the Development of Trade with respect to buy-back arrangements. Generally speaking, both works have been elaborated and designed in the same way. The purpose of these two guides is to give potential parties to either counterpurchase or "buy-back transactions a basis for understanding the nature of the arrangement in which they are engaging, to help them identify the problem areas associated with the various components of the deal, and to give them guidance in drawing up the necessary contractual documents which define the rights and obligations of the parties".[131]

Since both guides have addressed only the key issues of a typical counterpurchase or buy-back arrangement, a number of necessary issues have not been dealt with sufficiently. For example, only one sentence has been devoted to the issue of applicable law in both guides. The sentence is: "The parties should agree on the law which governs the contract used in the counterpurchase [or buy-back[132]] transaction and in accordance with which the contracts are to be construed." Certainly, there are a number of issues closely related to the applicable law for which such a short guide provides no key.

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131 ECE, *International Buy-Back Contracts* (UN, New York, 1990) at 1; ECE, *International Counterpurchase Contracts* (UN, New York, 1989) at 1.

132 In ECE, *International Buy-Back Contracts* (UN, New York, 1990) at 1.

4.2. The Commonwealth Secretariat Guide

The Commonwealth Secretariat has published a book entitled "Countertrade, Guidelines for Developing Countries".[133] The purpose of the work is to provide information and advice to Commonwealth developing countries which need assistance, having only limited countertrade experience. Since the Guidelines have been designed to serve as an aid for Commonwealth developing countries, the emphasis has been made to view countertrade from the developing countries' perspective.[134] Unlike the ECE and UNCITRAL works, only a small part of the work has been devoted to the contractual issues of countertrade. The Commonwealth Guidelines try to provide guidance to various aspects of countertrade such as selecting appropriate countertrade forms, the products to be exported or imported under countertrade, the incremental cost of countertrade, advice on the available services on countertrade programs, and some suggestions to governments of these countries in relation to supporting, monitoring and evaluating countertrade policies. The Guidelines contain an appendix of a few sample contracts and a list of organisations offering countertrade services.

4.3. The UNCITRAL Legal Guide on Countertrade

Due to the slow progress of economic development of developing countries, the UN General Assembly has issued resolutions on economic development and the establishment of the new international economic order. Taking into consideration the new economic order, the UN Commission on International Trade Law (UNCITRAL) at its eleventh session in

133 Commonwealth Secretariat, *Countertrade: Guidelines for Developing Countries* (Commonwealth Secretariat, London, 1988).

134 At 1.

1978 retained the subject of international barter or exchange in its program of work.[135] The report of the Secretary-General pointed out that "the law relating to barter or exchange transactions is relatively undeveloped, apparently because such transactions are not frequent on the domestic level".[136] The report concluded that since international barter-like transactions are often very complex and depart substantially from the simple model of classical barter, consideration should be given to the preparation of standard clauses dealing with these kinds of trade.[137] In 1984, the report of the Secretary-General, summing up the current activities of international organisations in the field of barter and barter-like transactions, concluded that "most of the studies on the subject indicate the problems encountered in such transactions are far more economic and financial than legal. However, even if an international uniform regulation were desired, the complexity of these transactions and their variety may militate against such a possibility."[138] At its 19th session, UNCITRAL suggested that work might be undertaken to ascertain and resolve the legal difficulties of countertrade.[139]

At its 21st session in 1988, UNCITRAL made a preliminary decision that it would be desirable to prepare a legal guide on drawing up countertrade contracts.[140] A number of reasons led UNCITRAL to take the decision. It was noted that a considerable part of international trade has been conducted by countertrade arrangements which pose many legal difficulties for the parties.[141] Since there were no optimal solutions to these contractual problems at a global level, UNCITRAL emphasised that its work would have particular

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135 UNCITRAL, *Yearbook* vol X (UN, New York, 1979) at 13.
136 At 37.
137 At 38.
138 UNCITRAL, *Yearbook* vol XV (UN, New York, 1984) at 328.
139 UNCITRAL, *Yearbook* vol XVII (UN, New York, 1986) at 31.
140 UNCITRAL, *Yearbook* vol XIX (UN, New York, 1988) at 8.
141 As above.

merit in view of its global representation and the wide distribution of its results.[142] The report of UNCITRAL at 21st session pointed out:

> It was considered that the most appropriate course of action would be to draw up a legal guide that would discuss legal issues typical of countertrade contracts and would provide assistance in drawing up such contracts. For example, it could provide advice on the contractual forms appropriate for countertrade transactions or on the relationship between contracts forming part of such a transaction.[143]

At its 22nd session, held in 1989, UNCITRAL, considering a report entitled "Draft Outline of the Possible Content and Structure of a Legal Guide on Drawing up International Countertrade Contract", decided that such a legal guide should be prepared.[144] At its 25th session, held in 1992, UNCITRAL reviewed the revised draft and approved the Legal Guide as follows:

> *The United Nations Commission on International Trade Law*,
>
> *Recalling* its mandate under General Assembly resolution 2205 (XXI) of 17 December 1966 to further the progressive harmonisation and unification of the law of international trade, and in that respect to bear in mind the interest of all peoples, and in particular those of developing countries, in the extensive development of international trade,
>
> *Noting* that an appreciable share of international trade is carried out through countertrade transactions,
>
> *Being of the opinion* that a legal guide on contractual issues in international countertrade transactions will be helpful to parties involved in such transactions, and in particular to parties from developing countries,
>
> 1. *Adopts* the UNCITRAL Legal Guide on International Countertrade Transactions;
>
> 2. *Invites* the General Assembly to recommend the use of the Legal Guide for international countertrade transactions;
>
> 3. *Requests* the Secretary-General to take effective measures for the widespread distribution and promotion of the use of the Legal Guide.[145]

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142 As above.
143 As above.
144 *Official Records of the General Assembly, Forty-forth Session,* (Supplement No 17 (A/44/17) paras 245-249.
145 UNCITRAL, *Yearbook* vol XXIII (UN, New York, 1992) at 18.

As requested, in 1993 the Secretariat edited and published the Legal Guide under the title of "UNCITRAL Legal Guide on International Countertrade Transactions".[146]

The Legal Guide is a valuable source for consultation for those engaging in countertrade deals. The focus of the Legal Guide is the drawing up of contractual clauses for international countertrade contracts by providing detailed analysis and information about drafting countertrade contracts with an emphasis on counterpurchase arrangements. It can also be consulted for other forms of countertrade. It is an outstanding work of UNCITRAL which countertraders should consult, especially those involved in drafting countertrade contracts. Since the Guide has been drafted at the universal level, there is little reference to national legal systems. A supplementary work is needed in each country in order to assess the guide in the light of that national legal system.

Conclusion

There is a trend in today's international trade to draft international transactions in a way leaving little to be decided by national laws. On the other hand, for many business people drafting individual contracts term by term is neither practicable or desirable. Particular groups of business people and internal or international bodies have developed general conditions of business, standard model contracts, standard terms and guidelines to help parties to draft contracts. The UNIDROIT Principles is a set of advanced general rules that can be used in countertrade contracts as a legal regime within which the contracts are to be

146 UNCITRAL, *Legal Guide on International Countertrade Transactions*, (UN, New York, 1993).

construed. In using model contracts, there is a danger that a party may fill in the blanks blindly without due consideration of its contents. Unlike contracts of adhesion, standard contracts in international business attract no particular remedy if they include unfair and oppressive terms.

Partial standardisation may be achieved by using standard terms prepared in advance for a particular aspect of a contract. INCOTERMS are a set of rules which define the legal meanings of trade terms used in international transactions to allocate the costs and risks between the parities. They can be used in a countertrade contract whenever sale of goods is involved. Apart from general conditions, standard forms and standard terms, there are certain guidelines which are valuable references for business people. They generally provide a broad understanding of countertrade contracts with some solutions to their difficulties and disadvantages. Considering these guides and other relevant works, later chapters will focus on the detailed contents of countertrade contracts and those issues to be covered in these contracts with a reference to the Australian legal system. A further chapter will also deal with those government regulations set forth in multilateral treaties to which Australia is a party to examine their impact on countertrade practices.

CHAPTER 7

Structuring Countertrade Contracts

Introduction

A countertrade transaction takes place when two sets of obligations in two opposing directions are connected to one another. For example, a countertrade transaction is concluded when a firm exports certain goods or services to an importing party and undertakes in return to counter-trade some products or to fulfil certain obligations to the importing party's benefit. For the sake of clarity, I shall call the first contract the *primary contract* and the second the *counter-trade contract* (with a hyphen). The whole arrangement covering the primary contract and the counter-trade contract is known as *countertrade* (without a hyphen). These two sets of obligations must be connected legally in one way or another to establish a countertrade transaction. If obligations in each direction are set out in separate contracts without any linkage between them, the contracts are conventional ones which have no peculiarity to be discussed here. The key issue which distinguishes two conventional contracts from a countertrade transaction is the link between these two contracts. This distinguishing element requires two things: structuring countertrade contracts in such a way to establish an appropriate link between different parts of a countertrade package and drafting the content of each contract in line with its reciprocal character. This chapter deals with the issue of selecting a structure for the countertrade package and the linkage between different contracts in the package. The next chapters will focus on the contents of these contracts which need to be shaped and drafted in response to their reciprocal nature.

1. The Structure of Countertrade Contracts

The primary step in planning and drafting efficient countertrade transactions is selecting an appropriate format. A poorly structured arrangement causes difficulties, exposing the whole transaction to nullification if something goes wrong in any of its components. Since a countertrade package consists of at least two sets of obligations in two directions being connected to each other, the selected structure must provide the best solution to the problem of linkage in the light of parties' needs. Despite variations in the form and structure, the main methods in structuring countertrade transactions are as follows: i) one single contract is drafted comprehensively enough to cover both the primary and counter-trade contracts; ii) two separate contracts for the primary contract and the counter-trade contract are entered into while each one has an appropriate clause linking it to the other; iii) two separate contracts are undertaken while only one of them has a term linking it to the other; and iv) two separate contracts are linked through a preliminary agreement signed previously or simultaneously. Each method has its own advantages or drawbacks which may suit particular countertrading parties depending on the type of the deal and the parties' needs.

In selecting an appropriate structure for countertrade contracts, one needs to find out whether a single contract covering details of both the primary contract and counter-trade obligations should be chosen or whether it is preferable to draft a separate contract for obligations in each direction. If two separate contracts are to be drafted, the linkage between the two also needs to be worked out.

1.1. Single-Contract Structure

When a single contract is chosen to cover the obligations of both primary and counter-trade contracts, it is generally presumed that these two sets of obligations are dependent on one another, even if the supply in one direction does not constitute payment for the other. This interdependence may mean that any failure in performance of obligations in one direction provides a means by which the other party may suspend or reject its own performance. Similarly, the termination of an obligation in one direction may give the other party a ground to terminate its own obligations. In other words, in a single contract structure any problem arising in relation to performance of obligations in one direction, such as non-delivery, non-payment and delay in performance, could influence performance in the other direction. This dependence is not always welcomed by the parties because using a single contract places the whole contract at risk if something goes wrong with one element of contract in one direction, irrespective of whether one party is responsible for that problem or not.[1] Therefore, since the primary contract is often to be fulfilled prior to performance of the counter-trade contract, the original exporter may wish to separate it from the counter-trade contract to avoid any suspension or delay in payment of the primary sale contract.

1 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 15.

In most cases of countertrade, the kind of obligations set out in the primary contract is different to that of the counter-trade contract. The performance of each contract may need its own arrangement with reference to delivery, payment, financing, and so on. Using two separate contracts provides greater flexibility to the parties to incorporate distinct contractual terms in each contract. At times, the details of the primary contract are certain but the contents of the counter-trade contract need to be worked out at some time in the future. Choosing a multiple-contract structure gives the parties an opportunity to finalise the contract for which the contractual terms are certain, keeping it unencumbered by potential problems which may arise later in relation to the other contract.

Another advantage of the multiple-contract structure is facilitation of the assignment of the counter-trade commitments. Where assignment of the rights and obligations arising from the counter-trade contract is likely, a separate counter-trade contract containing all the details of counter-trade obligations and rights is advantageous to both the assignor and assignee. The need for a separate contract is more pressing when the assignment is to release the original exporter from its liability as to the obligations set out in the counter-trade contract.

Finance to carry out the transaction is more easily obtained when separate contracts are drafted for primary and counter-trade contracts. Generally speaking, the primary contract is financed through supplier credit or buyer credit.[2] Under supplier credit, the exporter who agrees to a deferred payment receives finance from a bank in the form of a loan or by way of discounting the bill or notes drawn or endorsed by the buyer. The bank may require the exporter to assign to it the payment claim under the primary sale as security. When the

2 Horn, "Payment and Financing Arrangements in International Trade" in Horn (ed), *The Law of International Trade Finance*, (Kluwer, Deventer, the Netherlands, 1988) at 18.

payment is at risk of a set-off claim or other counterclaims as a result of connecting two supplies, the bank may not be interested in such assignment. In the case of the buyer credit, the bank provides finance to the importer to enable it to meet its obligation. When a single contract is chosen to cover the primary and counter-trade contracts, a bank may not want to risk providing credit to a buyer relying on the expected income of counter-trade contract.[3] Similarly, obtaining export risk guarantees from either government export credit agencies or from the private sector is easier when the countertrade arrangement is structured as contract two separate contracts.[4]

1.2. Multiple-Contract Structure

When a multi-contract structure has been chosen for countertrade, the issue of linkage between the primary sale and the counter-trade contract should be carefully addressed by the parties. As mentioned above, they may be connected to each other by including a cross reference in both contracts, providing a linking clause in one of them, or establishing a protocol. As regards a cross reference clause, the advantages and drawbacks of a single-contract structure generally apply. By making such a linkage, one contract becomes prima facie dependent on the other, being exposed to the counterclaims arising from the other side's performance. Obtaining finance or export risk guarantees also becomes difficult when such dependence exists. As a result, the initial exporter may insist on drafting the primary contract totally independently from the counter-trade contract to keep its export unencumbered by difficulties arising as a result of the reference made to the counter-trade

3 Townsend, *The Financing of Countertrade* (Butterworths, London, 1986) at 26.

4 Mishkin, "Countertrade and Barter: The Basic Legal Structure" (1986) 14 *International Business Lawyer* 7 at 8. It is also true for the policy of the Export Finance and Insurance Corporation (EFIC) in Australia. Koh, Hiscock & Allan, "Countertrade: the Problem of Linkage in International Counterpurchase Agreements" (1990) 4 *ICCLR* 97 at 100.

contract. On the other hand, the exporter may also insist that the counter-trade contract should be drafted dependent on the primary contract, so that it will release itself from the counter-trade obligations if something goes wrong with the export contract. However, the original importer may be in favour of drafting the primary contract dependent on the counter-trade contract to ensure that the original exporter will comply with its commitments under the counter-trade contract.

A common way of structuring countertrade transactions is drafting the primary contract totally independently from other contracts, accompanied by a protocol which specifies the obligations to be undertaken under the counter-trade contract and the linkage between the primary contract and the counter-trade contract.[5] The counter-trade contract is to be drafted later in accordance with the specifications spelled out in the protocol. Both the primary and the counter-trade contracts are conventional contracts which have no linkage connecting one to another. Rather, the issue of reciprocity and linkage is provided in the protocol. Since the specified provisions of countertrade are often spelled out in protocols (preliminary agreements), it is necessary to discuss protocols to consider whether they are an appropriate legal means for countertrade purposes.

2. Protocols

A preliminary agreement may be concluded to facilitate reaching final agreements at some stage of the countertrade negotiations. Various expressions have been used for such

5 One of the advantages of this way is that both the primary sale and the counter-trade contract are prima facia independent from each other. This independence helps the parties to avail themselves of services designed for normal transactions, such as banking services, export guarantees, and so on.

preliminary arrangements, such as *protocol*, *letter of intent*, *letter of undertaking*, *letter of understanding*, *frame contract*, *memorandum of understanding* and so on.[6] However, the term *protocol* has been used widely for preliminary arrangements made for countertrade purposes. Protocols are generally undertaken either prior to finalising contracts in both directions or simultaneously with signing the contract in one direction. In the latter situation, the primary contract is entered into concurrently with a protocol by which the original exporter undertakes certain obligations for the importer's benefit. Underlying definitive contracts should be drafted in accordance with the specifications set out in the protocol.

2.1. The Definition and Rationale of Protocols

A protocol is a preliminary written instrument concluded during negotiations in anticipation of future countertrade contracts. The distinguishing characteristic of a protocol is its introductory status to final contracts which are to be entered into later. Irrespective of their legal weight, protocols vary from a mere declaration of the parties' intention to negotiate to elaborate and lengthy documents which contain almost all aspects of future contracts. There are many reasons underlying the resort to a protocol for countertrade purposes. The following are some of the key reasons for using protocols:

i) In some cases the engagement of the parties in countertrade is preceded by a protocol entered into by their governments. Two governments, generally from the developing

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6 Lake & Draetta, *Letter of Intent and Other Precontractual Documents, Comparative Analysis and Forms* (Butterworth Legal Publishers, 1989, USA) at 4.

world,[7] sign a protocol to pave the way for countertrade practices.[8] The actual purposes of these government-to-government bilateral arrangements vary from case to case. They may range from a vague declaration of their interest in reciprocal deals to more formal and structured agreements. Generally speaking, these protocols are aimed at accelerating the process of countertrading between two countries, providing access market privileges to their countertraders upon preferential terms, facilitating the exchange process and removing countertrade obstacles. They may go further, providing an obligation to engage in certain countertrade transactions over a specified period of time and up to a particular amount of money. They may set up a framework identifying the authorities, procedures and financial arrangements within which the implementation of countertrade agreements is to be made. These protocols may also identify some procedures for determining the prices, the method of payment, the products available for countertrade, the actual sellers and buyers and other relevant issues. A number of definitive countertrade transactions have been initiated as a result of these government-to-government protocols.

ii) Reaching final countertrade contracts, especially when complicated and lengthy contracts are involved, may require considerable time to work out all aspects of the arrangement.[9] The parties may not want to forget or to lose what they have achieved during a phase of negotiations to be continued later by the same negotiators or by other members of the

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7 Argentina in Latin America, India and Pakistan in Asia, and Iran in the Middle East have a history of government-to-government protocols for countertrade purposes with Eastern European countries or with other less developed countries. Latin American Newsletters, "*Latin America Special Report*" (September, 1986) at 9; available in Lexis-Nexis, Financial News Library.

8 By contrast, a letter of intent may provide some obstacles in the way of countertrade. For example, the US-Czechoslovakia Trade Agreement and Accompanying Letters of Understanding of September. 12, 1990 calls on the parties to not "require or encourage nationals and companies of the United States or Czechoslovakia to engage in barter or countertrade". 29(4) *International Law Materials* (1990) 902 at 905.

9 Koh, "Countertrade: Legal Issues and Techniques" in *Fifteenth International Trade Law Conference* (Canberra, 4-6 November 1988) at 485.

negotiating team.[10] Since the parties are concerned about negotiations not being forgotten or breaking down and are equally not satisfied to draft the final agreement, a protocol can be undertaken to record what they achieve during a negotiation round, to further negotiations in good faith, or to set up a framework for future negotiations.[11]

iii) Many issues may not be clear in countertrade arrangements, at least at the beginning of negotiations: a countertrade demand may be forwarded to an exporting partner having no immediate idea how to handle the demand;[12] the goods proposed for counter-trading may not be available at that time and must be chosen from a list which has not yet been worked out or must be determined in accordance with an established procedure; the exporting partner may need to make some enquires as to whether it is possible to resell the counter-traded goods in a given market directly or through trading houses or brokers and upon which conditions; and, the trading parties may need to make certain contracts with various suppliers, consumers, contractors, financial institutions, or trading houses prior to reaching final countertrade contracts.

The finalisation of these issues is time-consuming work, generating expenses for the parties. In these circumstances a protocol is an assurance which indicates the seriousness of the parties' intention to further negotiations or to work out their differences upon an agreed basis.[13] Alternatively, the protocol may contain certain aspects of the final agreement, leaving some others open to future negotiations. For example, all aspects of a countertrade

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10 Lake & Draetta, *Letter of Intent and Other Precontractual Documents, Comparative Analysis and Forms* (Butterworth Legal Publishers, 1989, USA) at 16.

11 Paterson, "The Contract to Negotiate in Good Faith: Recognition and Enforcement" (1996) 10 *Journal of Contract Law* 120 at 122.

12 Koh, "Countertrade: Legal Issues and Techniques" in *Fifteenth International Trade Law Conference* (Canberra, 4-6 November 1988) at 485.

13 Lake & Draetta, *Letter of Intent and Other Precontractual Documents, Comparative Analysis and Forms* (Butterworth Legal Publishers, 1989, USA) at 12.

agreement may be agreed on, except the price or the kind of goods which is left open for later determination.

iv) In some cases the approval or consent of a third party is necessary for a given countertrade deal to be implemented. Obtaining such approval or its exact conditions may not be certain prior to presenting the given arrangement to the third party for approval. For example, when a countertrade transaction must be presented to a government agency for approval, an application, accompanied by a protocol containing the details of the contract, has to be lodged. Similarly, when a financial arrangement with a bank is not practicable before specifying the details of the deal, a protocol is entered into to be presented to the bank to finance the deal.[14] In cases where the outcome of the third party's approval is not expected to require an adjustment in the contract terms, the parties may make ultimate contracts conditional on the third party's approval. However, if finalising certain terms of the contract depends on the details of the approval, the parties will need to formulate a protocol to be presented to the third party, opening the gate for further negotiations to adjust certain terms of the contract in accordance with the details of the approval. The final countertrade contracts, therefore, will be concluded in line with the terms agreed on in protocols and specifications stated in the approval.[15]

v) The parties to a countertrade arrangement may agree on all terms, leaving none of the details to be worked out later. Nevertheless, they may not be able to sign the ultimate contracts, due to some formal procedures that are to be taken prior to finalising the deal.

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14 The Export-Import Bank of the United States (EX-IM Bank), for example, provides *preliminary commitments* to the exporters or importers which lodge an application setting forth the details of their transaction. Upon the information given by the applicant, EX-IM Bank issues a non-binding preliminary commitment which shows the details of the financial support. Corette III, "Export Sales Transactions" (1981-82) 7 *North Carolina J International L & Commercial Reg* 49 at 61.

15 Fox, *International Commercial Agreements* (Kluwer, Deventer, the Netherlands, 2nd ed 1992) at 127.

Sometimes, the parties postpone signing the ultimate contracts for some reason, such as expecting tax or tariff concessions which are going to come into force in the near future. In these situations, a protocol may be used not because some terms remain to be negotiated later, but because the parties prefer to sign the ultimate contracts at some time in the future with all the terms previously agreed on.[16]

vi) A protocol may be undertaken by a party as a condition of submitting a tender. Under a countertrade policy in Indonesia, for example, every foreign exporting firm that wants to bid on government procurements in excess of $750,000 is required, among other things, to submit a letter of undertaking whereby the foreign exporter undertakes to counter-trade Indonesian products.[17] A standardised letter of undertaking for that purpose has been set by the Indonesian Department of Trade and Cooperatives, specifying the details of the counter-trade commitment.[18]

2.2. The Legal Weight of Protocols

A protocol may be complied with in terms of the parties' course of business and economic benefits, irrespective of its legal status.[19] The parties may need to respect the protocol in order to maintain their trading relationship with one another, demonstrating their good faith in conducting business activities and preserving reputations.[20] On the other hand, business

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16 Farnsworth, "Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations" (1987) 87 *Columbia L Rev* 217 at 251.

17 *East Asian Executive Reports* (September 15, 1984) at 9.

18 A copy of this standard letter of undertaking has been reprinted in Rubin, *The Business Manager's: Guide to Barter, Offset and Countertrade* (The Economist Intelligence Unit, London, 1986) at 86.

19 Lake & Draetta, *Letter of Intent and Other Precontractual Documents, Comparative Analysis and Forms* (Butterworth Legal Publishers, 1989, USA) at 11.

20 Beale & Dugdale, "Contracts Between Businessmen: Planning and the Use of Contractual Remedies" (1975) 2 *British J L & Society* 45 at 47.

people may deal with protocols in certain circumstances only as morally binding, preserving their right to reject the final agreements for any reason whatsoever.[21] Despite different approaches which may be taken by business people, from a legal viewpoint protocols, like other contracts, should be drafted with due consideration to minimise unexpected outcomes if later disputes arise, especially when complicated transactions are involved or the risk of disputes is high.

The legal effect of protocols should be determined by reference to two issues: their content and the applicable law. The whole transaction should be examined to ascertain its legal weight. The label given to it by the parties may not determine its legal consequences.[22] In addition to the content of the protocol, various legal systems may give different effects to a protocol.[23] A protocol may give rise to a binding agreement under one legal system and be non-binding under another. Since the contents of protocols may be construed differently in various legal systems, what the parties want to achieve by means of drafting a protocol should be analysed with reference to the governing law. Here, the expectations of the countertrading parties are examined in the light of the Australian legal system to see on which conditions they may reach their goals.

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21 Knapp, "Enforcing the Contract to Bargain" (1969) 44 *NY Uni L Rev* 673 at 679.

22 Schmidt, "Preliminary Agreements in International Contract Negotiation" (1983) *6 Houston J International L* 37 at 37; *Benjamin's Sale of Goods* (Sweet & Maxwell, London, 3rd ed 1987) at 26 & 35.

23 See generally Lake, "Letters of Intent: A Comparative Examination Under English, US, French and West German Law" (1984) 18 *Geo Wash J International L & Econ* 331.

2.2.1. Establishing a Non-binding Protocol

An intention to enter into a legal relationship is essential for making a contract under the Anglo-Australian legal system.[24] Such an intention is, however, presumed in commercial and business dealings, unless any indications to the contrary are evident.[25] Sometimes, the parties use a protocol to set up a framework for further negotiations, to establish certain grounds upon which the parties are to base their final agreements, or to demonstrate their willingness to counter-trade some products from the original importer, without being bound in any case to do so. If such intention becomes evident from the agreement, Australian courts will give no legal force to it.[26] In *Rose and Frank v JR Crompton,* Scrutton LJ said:

> Now it is quite possible for parties to come to an agreement by accepting a proposal with the result that the agreement concluded does not give rise to legal relations. The reason of this is that the parties do not intend that their agreement shall give rise to legal relations. This intention may be implied from the subject matter of the agreement, but it may also be expressed by the parties. In social and family relations such an intention is readily implied, while in business matters the opposite result would ordinarily follow.[27]

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24 In *Placer Development v The Commonwealth* (1969) 121 CLR 353 at 366, Windeyer J remarked:

> That such an intention is of the essence of a valid contract has been asserted in English cases for a long time past, certainly since Lord Atkin, then Atkin L.J., said so in *Balfour v. Balfour* (1919) 2 KB 571, at p 578 , and in *Rose and Frank Co. v. J.R. Crompton and Bros. Ltd.* (1923) 2 KB 261, at p 293 . Recent examples of acceptance of the doctrine and the repetition of the phrases in which it has been expounded are to be found in *Jones v. Padavatton* (1969) 1 WLR 328 and *Ford Motor Co. Ltd. v. Amalgamated Union of Engineering and Foundry Workers* (1969) 1 WLR 339.

Although the intention to enter into a legal relationship is essential for making a contract, it is not necessary that all the legal consequences of a contract should also be intended, nor is a subjective test needed in order to declare a contract enforceable. In *Placer*, Windeyer J remarked:

> I venture to say ... that whether there is a voluntary assumption of a legally enforceable duty is not to be decided by asking whether or not the parties had expressed or exhibited an actual and positive intention that their agreement was to result in legal obligations. It depends rather on an inference to be drawn from the subject matter and nature of their agreement, and other circumstances.

25 *Rose and Frank Co v JR Crompton and Bros* [1923] 2 KB 261 at 288.

26 See generally: Carter & Harland, *Contract Law in Australia* (Butterworths, Australia, 3rd ed, 1996) at 154; and Greig & Davis, *The Law of Contract* (Law Book Co, NSW, 1987) at 187.

27 [1923] 2 KB 261 at 288.

The parties should insert sufficient indications into their agreement that they do not intend to create a contract giving rise to legal rights and obligations if they wish to avoid the potential enforceability of a protocol. In *Rose* for example, the following clause inserted into the agreement was honoured by the court:

> This arrangement is not entered into nor is this memorandum written, as a formal or legal agreement, ... but it is only a definite expression and record of the purpose and intention of the parties concerned.[28]

As a result, in a preliminary countertrade agreement signed by the parties, the intention to create a legal relation is presumed, unless otherwise made evident in the agreement. In cases where protocols are of no legal effect, the subsequent arrangements entered into by the parties in accordance with these non-binding protocols are enforceable. In this connection, in *Rose* Lord Phillimore pointed out: "Any actual transaction between the parties, however, gave rise to the ordinary legal rights; for the fact that it was not of obligation to do the transaction did not divest the transaction when done of its ordinary legal significance."[29]

2.2.2. Creating an Obligation to Negotiate

In some situations a protocol is crystallised in order to establish a legal ground for obliging the parties to adhere to a negotiation schedule, to negotiate subsequent agreements in good faith, or to make their best effort to reach final agreements. They do not intend to commit

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28 [1923] 2 KB 261 at 267. As another example, in US the following term included in a preliminary arrangement was honoured in *Terracom Development Group v Coleman Cable & Wire Co*, 365 NE 2d 1028 (1977) at 1029:

> This letter of intent is not binding upon us in any way nor is the conditional offer contained herein binding upon us except to the extent that it reflects our intent to enter into a definitive written agreement with respect to the sale of the property described above upon the terms and conditions herein contained. This letter of intent is expressly conditioned upon our entering into a mutually satisfactory definitive written agreement in the form satisfactory to our counsel.

29 [1925] AC 445 at 455.

themselves to reaching final contracts, but rather they desire further negotiations in an organised way or in good faith.[30] Generally speaking, the Anglo-Australian legal system has been hesitant to recognise an agreement to negotiate as an enforceable and valid contract. In *Courtney v Tolaini*, Lord Denning pointed out:

> If the law does not recognise a contract to enter into a contract (when there is a fundamental term yet to be agreed) it seems to me it cannot recognise a contract to negotiate. The reason is because it is too uncertain to have any binding force. No court could estimate the damages because no one can tell whether the negotiations would be successful or would fall through; or if successful, what the result would be. It seems to me that a contract to negotiate, like a contract to enter into a contract, is not a contract known to the law.[31]

The key reasons given for unenforceability of an agreement to negotiate are the uncertainty of the content of the agreement, the difficulty in establishing breach, and the problem in calculating damages.[32]

Nevertheless, in *Hillas v Arcos,* Lord Wright argued conversely:

> There is then no bargain except to negotiate, and negotiations may be fruitless and end without any contract ensuing: yet even then, in strict theory, there is a contract (if there is good consideration) to negotiate, though in the event of repudiation by one party the damages may be nominal, unless a jury think that the opportunity to negotiate was of some appreciable value to the injured party.[33]

Although this argument was rejected by the majority and not followed later by the Court of Appeal in *Courtney,* it has been supported by the NSW Court of Appeal in *Coal Cliff Collieries v Sijehama.*[34] In this case Kirby J, with whom Waddell AJA agreed, pointed out:

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30 Paterson, "The Contract to Negotiate in Good Faith: Recognition and Enforcement" (1996) 10 *Journal of Contract Law* 120 at 122.

31 [1975] 1 All ER 716 at 720; the following remark has been cited with approval by Menzies J. in *Thorby v Goldberg* (1965) 112 CLR 597 at 607:.

> Sugerman J. said: 'It is a first principle of the law of contracts that there can be no binding and enforceable obligation unless the terms of the bargain, or at least its essential or critical terms, have been agreed upon. So, there is no concluded contract where an essential or critical term is expressly left to be settled by future agreement of the parties.'

32 *Courtney v Tolaini* [1975] 1 All ER 716 at 720.

33 [1932] All ER 494 at 505.

34 (1991) 24 NSWLR 1.

> I reject the notion that such a contract is unknown to the law, whatever its term. I agree with Lord Wright's speech in *Hillas* that, provided there was consideration for the promise, in some circumstance[s] a promise to negotiate in good faith will be enforceable, depending upon its precise terms.[35]

The enforceability of an agreement to negotiate in certain circumstances was endorsed later in *Trawl Industries of Australia v Effem Foods*.[36] Here, Kirby J, summarising his argument in *Coal*, said: "I concluded that a promise to negotiate a large commercial dealing in good faith might, in particular circumstances, be enforceable. Such enforceability would depend upon the precise terms of the promise, as construed from the words used in the particular contract."[37]

The trend of Australian courts to recognise, at least to some extent, the enforceability of an agreement to negotiate is a response to the needs of the business community, particularly when complicated agreements are involved which require a lot of preparation, negotiations and expense.[38] The peculiarity of these arrangements is well-stated by Lord Wright in *Hillas* that:

> in contracts for future performance over a period, the parties may not be able nor may they desire to specify many matters of detail, but leave them to be adjusted in the working out of the contract. Save for the legal implication I have mentioned, such contracts might well be incomplete or uncertain; with that implication in reserve they are neither incomplete nor uncertain. As obvious illustrations I may refer to such matters as prices or times of delivery in contracts for the sale of goods, or times for lading or discharging in a contract of sea carriage.[39]

In *Hughes Aircraft Systems International v Airservices Australia,* Hughes, who was unsuccessful in a tender awarded by the Civil Aviation Authority (CAA), sued the CAA for breaking its obligation to conduct the tender process fairly and in accordance with defined

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35 At 26.
36 (1992) 27 NSWLR 326.
37 (1992) 27 NSWLR 326 at 332.
38 In the US the trend is also towards the recognition of agreements to negotiate in good faith. See Lake & Draetta, *Letters of Intent and Other Precontractual Documents* (Butterworth, USA, 1989) at 125.
39 *Hillas v Arcos* [1932] All ER 494 at 504.

procedures and criteria made by the contract, representation or promise.[40] The Federal Court of Australia found in favour of Hughes on two bases: a preliminary contract which specified the procedure for evaluating the tenders and a general implied duty of good faith and fair dealing. The court declared a letter sent by the CAA and signed by Hughes a valid preliminary contract under which the CAA was required to follow a particular procedure in choosing the successful bidder.

This argument can be extended to any preliminary agreement which requires a party to follow a procedure to reach the final contracts. This case is also significant because the court has extended the duty of fair dealing, which was supported in *Renard Constructions v Minister for Public Works*[41] with respect to the performance of the contract, to preliminary contracts and opened the gate for its extension even to cases where a valid contract is absent. Finn J said that "the implied duty [of fair dealing] existed in 'every contract'. I make this particular observation because, as later discussed, a duty to act fairly in some form appears to have been accepted in other Commonwealth jurisdictions in pre-award contract contexts".[42] By reference to certain cases,[43] Finn J added: "It is not at all surprising that, even absent the finding of a contract, courts have assumed that 'obligations to act fairly' in the treatment of tenderers can still arise".[44] This trend is in line with

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40 [1997] 558 FCA (30 June 1997); available in the AustLII, on the WEB at http://search.austlii.edu.au

41 (1992) 26 NSWLR 234. In this case Priestley JA said at 268 that

> people generally, including judges and other lawyers, from all strands of the community, have grown used to the courts applying standards of fairness to contract which are wholly consistent with the existence in all contracts of a duty upon the parties of good faith and fair dealing in its performance. In my view this is in these days the expected standard, and anything less is contrary to prevailing community expectations.

42 [1997] 558 FCA (30 June 1997); available in the AustLII, on the WEB.

43 *Pratt Contractors v Palmerston North City Council* [1995] 1 NZLR 469 at 478.

44 [1997] 558 FCA (30 June 1997); available in the AustLII, on the WEB.

expectations of business people which have been acknowledged in many national[45] or international laws.[46]

2.2.3. Creating an Obligation to Contract

Countertraders often need to agree on some general aspects of a countertrade transaction and leave some others such as prices, times of delivery and so on for later agreements. The parties' intentions are to bind themselves to what they have agreed so far in the protocol and to undertake to agree on other issues in the future. To see whether these protocols, generally referred to as *contract to contract*, are enforceable or not, five distinct situations should be distinguished.

First, the protocol containing all terms of the future contract requires the parties to execute a formal document in accordance with the terms incorporated in the protocol. Business people may agree on the terms of a countertrade transaction in a protocol and leave the final contracts to be drafted precisely by their lawyers. This kind of contract to contract is generally valid and enforceable under Anglo-Australian law.[47] In *Chillingworth v Esche*, Sargant L J said: "In the strictest sense of the words the Court will often enforce a contract to make a contract. The specific performance of a formal agreement of purchase is the enforcement of a contract to make a contract".[48] This assertion was endorsed in *Morton v Morton*,[49] where a protocol requiring the parties to "enter into a separation deed containing

45 Seddon, *Government Contracts* (Federation Press, Sydney, 1995) 212ff; Cohen, "Pre-Contractual Duties: Two Freedoms and the Contract to Negotiate" in Beatson & Friedmann (ed), *Good Faith and Fault in Contract Law* (Clarendon Press, Oxford, 1995) at 29-30.

46 Article 1.7 of the UNIDROIT Principles.

47 See generally: Lűcke, "Arrangements Preliminary to Formal Contracts" (1967) 3 *Adelaide L Rev* 46.

48 [1924] 1 Ch 97 at 113.

49 [1942] 1 All ER 273.

the following clauses" was honoured.[50] In *Masters v Cameron*, it was said that when the parties "have reached finality in arranging all the terms of their bargain and intend to be immediately bound to the performance of those terms, but at the same time propose to have the terms restated in a form which will be fuller or more precise but not different in effect", they are bound to the agreement.[51] Similarly, a protocol containing virtually all aspects of an enforceable contract is enforceable despite the label given to it by the parties.[52]

Second, in cases where the parties work out all the terms of a contract in a protocol, intending to enter into a legally binding arrangement upon approval or consultation of a third party or upon occurrence of external events, the protocol is unenforceable either because the negotiation process is still not finished or the agreement is conditional on these matters which have not yet occurred.[53]

Third, since in common law consideration is necessary if a contract is to be enforceable, a protocol without consideration may not give rise to enforceability.[54] A protocol is more likely to be unenforceable under this doctrine in two situations: first, where the protocol is unilaterally undertaken by a party; and second, where the protocol is executory only on one side. In cases where the protocol is a framework for both the primary contract and the counter-trade contract, the need for consideration is satisfied because a mutual commitment

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50 *Chitty on Contracts: General Principles* (Sweet & Maxwell, London, 27th ed 1994) at 147.

51 (1954) 91 CLR 353 at 360.

52 Lake & Draetta, *Letter of Intent and Other Precontractual Documents, Comparative Analysis and Forms* (Butterworth Legal Publishers, 1989, USA) at 16.

53 *Masters v Cameron* (1954) 91 CLR 353; see also Farnsworth, "Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations" (1987) 87 *Columbia L Rev* 217 at 253.

54 In *Hughes Aircraft Systems International v Airservices Australia* (1997) 558 FCA [available in the AustLII on the Web], it was argued by the CAA that the preliminary agreement, under which the CAA was to follow a specific procedure in the tendering process, was without consideration. In reply to this argument, Finn J said: "For consideration purposes, Hughes' participation would equally have been enough even if it could be said to have reserved the right to withdraw at any time, or in specified circumstances, or whenever."

is undertaken by the parties. Lack of consideration is, however, a concern in countertrade cases where the protocol requires only the original exporter to counter-trade certain products from the original buyer, because the agreement is executory only on one side.

The lack of consideration in these protocols can be managed through two methods: i) The protocol is considered as part of a broad contract which covers the primary contract and counter-trade contract alike. Since there is no need for each part of a contract to have its own consideration, the protocol is enforceable if the whole contract has consideration. ii) It is also possible to manage the lack of consideration in a protocol by the device of collateral contracts.[55] Under the collateral doctrine, the consideration for the collateral contract is provided by concluding the main contract.[56] Since the primary contract is entered into by the initial importer in expectation of the counter-trade contract, the consideration for the protocol is derived from the primary contract.

Fourth, when a protocol requires the parties to enter into a contract, without specifying the key issues of the future contract, the agreement, which is similar to a contract to negotiate, is not generally enforceable under Anglo-Australian law.[57] In *Von Hatzfeldt-Wildenburg v Alexander*, Parker J said that "the law does not recognise a contract to enter into a contract".[58] In *Coal Cliff Collieries,* Handley JA said: "It is established law both in England

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55 Koh, Hiscock & Allan, "Countertrade: the Problem of Linkage in International Counterpurchase Agreements" (1990) 4 *ICCLR* 97 at 102.

56 In *David Securities v Commonwealth Bank of Australia* (1992) 175 CLR 353 at 365, Mason CJ said:

> Collateral contracts are so called not because they are subordinate or of lesser importance (although they may well be, depending on the facts of the case), but because they impinge upon and are related to another contract.

57 In *Booker Industries v Wilson Parking* (1982) 149 CLR 600 at 604 a majority of the High Court (with whom Brennan J agreed) remarked: "It is established by authority, both ancient and modern, that the courts will not lend their aid to the enforcement of an incomplete agreement, being no more than an agreement of the parties to agree at some time in the future."

58 [1912] 1 Ch 284 at 288.

and Australia that agreements to agree or contracts to make contracts containing terms which have not yet been ascertained are not legally enforceable".[59] Lord Wensleydale in *Ridgway v Wharton* reasoned that an "agreement to enter into an agreement upon terms to be afterwards settled between the parties is a contradiction in terms. It is absurd to say that a man enters into an agreement till the terms of that agreement are settled. Until those terms are settled he is perfectly at liberty to retire from the bargain."[60] However, it can be argued that a contract to make a contract puts an obligation on the parties to use their best endeavours to reach agreement with the other,[61] to make themselves available for negotiations, and to not take any unreasonable position during the negotiations.

Fifth, in many cases of countertrade a protocol with open terms is undertaken which specifies certain terms of the contract, leaving some others to be settled later. An agreement with open terms may imply that the parties are still in negotiation, not intending to be bound if they fail to agree on undecided terms.[62] If such an intention becomes evident from the agreement, the agreement will be unenforceable due to lack of intention to be legally bound.[63] If such an intention is not evident, a court may declare a protocol with open terms enforceable upon satisfaction of two conditions: the critical part of the agreement must not be left undetermined and the determination of open terms must not be

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59 (1991) 24 NSWLR 1 at 38.

60 (1857) 6 HLC 238 at 305.

61 Article 5.5(2) of the UNIDROIT Principles provides: "To the extent that an obligation of a party involves a duty of best efforts in the performance of an activity, that party is bound to make such efforts as would be made by a reasonable person of the same kind in the same circumstances."

62 Farnsworth, "Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations" (1987) 87 *Colombia Law R* at 256.

63 It is not true to assume that intentional incompleteness is per se persuasive evidence that the parties do not intend to conclude a binding contract, especially in commercial deals. Farnsworth, "Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations" (1987) 87 *Colombia L Rev* at 256-257.

left to agreement by the parties. These requirements have been mentioned in *May & Butcher v the King* and quoted by Handley JA in *Coal*:

> It has long been a well recognised principle of contract law that an agreement between two parties to enter into an agreement in which some critical part of the contract matter is left undermined is no contract at all. ... To be a good contract there must be a concluded bargain, and a concluded contract is one which settles everything which is necessary to be settled and leaves nothing to be settled by agreement between the parties. Of course it may leave something which still has to be determined, but then that determination must be a determination which does not depend upon the agreement between the parties.[64]

Therefore, if important and essential matters of a contract are left subject to further agreement or if the parties fail to provide some machinery to determine the undecided terms, the whole contract is unenforceable.[65] In *State Trading Corporation v Golodetz*, Kerr LJ pointed out that "the [original] seller's commitment to the countertrade transaction might not be enforceable in law, but only as a matter of commercial morality, because a number of essential terms would clearly require negotiation and agreement, in particular the description and price of the goods to be [counter]-exported".[66] It is, however, to be noted that if the vague or incomplete part of the contract is severable from the rest, courts incline to uphold the rest, ignoring the incomplete part.[67] Nevertheless, in some cases the emphasis has been placed only on whether a mechanism or a formula has been established in the agreement to ascertain the undetermined terms or not. If such a mechanism or formula is

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64 [1934] 2 KB 17 at 20-21; *Coal Cliff Collieries v Sijehama* (1991) 24 NSWLR 1 at 40.

65 In this connection, Professor Lűcke said: "A contract is too vague and uncertain to be enforceable if the parties have failed to settle the essential terms (*e.g.*, the terms specifying subject matter and price in contracts of sale)." Lűcke, "Illusory, Vague and Uncertain Contractual Terms" (1977-78) 6 *Adelaide L Rev* 1 at 24.

66 [1989] 2 Lloyd's L R 277 at 283.

67 This general principle is stated by Knox CJ in *Life Insurance Co of Australia v Phillips* (1925) 36 CLR 60 at 72:

> When a contract contains a number of stipulations one of which is void for uncertainty, the question whether the whole contract is void depends on the intention of the parties to be gathered from the instrument as a whole. If the contact be divisible, the part which is void may be separated from the rest and does not affect its validity.

See also, Carter & Harland, *Contract Law in Australia* (Butterworths, Australia, 3rd ed 1996) at 83.

provided in the agreement, it is less important whether the undecided terms are essential or not. In *Booker Industries v Wilson Parking*, it was mentioned that "it is also well established that the parties to a contract may leave terms - even essential terms - to be determined by a third person".[68]

When some aspects of an agreement are intentionally left to be settled later, the agreement is enforceable only if the determination does not depend upon the agreement between the parties or if it does, a subsequent agreement has been reached.[69] In other words, an incomplete agreement is valid if the court can fill the gaps through applying some formula provided in the agreement or deduced from the parties' course of dealings, or through referring to a mechanism established by the parties. While reference to a reasonable price or a fair valuation is an example of providing a formula for determining the price,[70] an example of establishing a mechanism to determine the price is reference to a third party to fix it.[71] An incomplete agreement can be enforceable because rules of law or the standard of reasonableness supply solutions to the gaps in the agreement.[72] In sale of goods, for example, if the parties are silent on the details of the agreement, they will be determined by the law or through reasonable standards.[73] As Williams J said in *York Air Conditioning and Refrigeration v the Commonwealth,* if "the parties have agreed to leave something which

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68 (1982) 149 CLR 600 at 604.

69 *Australian and New Zealand Banking Group v Frost Holdings* [1989] VR 695 at 701.

70 In *Hall v Busst* (1960) 104 CLR 206 at 245, Windeyer J pointed out:

> When parties agree to sell for a reasonable price or at a fair valuation they do not leave an essential term of their bargain for further agreement, so that their agreement is incomplete. It is complete. They have fixed the price by a measure that the law knows. If they disagree as to what sum of money fills that measure, a court will determine it, at common law courts by a jury.

71 *Foster v Wheeler* (1888) 38 ChD 130; *Axelsen v O'Brien* (1949) 80 CLR 219. See also: Greig, *The Law of Contract* (Law Book Co, NSW, 1987) at 376ff.

72 In *Milne v Attorney-General for Tasmania* (1956) 95 CLR 460 at 473, the High Court said that "no contract is concluded until the parties negotiating are agreed upon *all* the terms of their bargain - unless indeed the terms left outstanding are 'such as the law will supply'."

73 However, the law cannot complete the contract if the parties decide to settle undetermined terms from time to time. See for example, Section 13 of the Goods Act 1958 (VIC).

has still to be determined, but the determination does not depend upon the agreement of the parties", "[t]he issue is one of the fact capable of being determined by the Court if the parties disagree about it".[74] As a result, if the court can spell out adequate machinery for determining the terms left open, it will hold that there is no uncertainty leading to unenforceability.[75]

In cases where an assured method of settling undetermined matters is not established in the agreement, Australian courts may give no contractual force to the agreement. Nevertheless, the trend in England[76] and New Zealand[77] is to enforce these agreements, if ascertainment of the undecided matters is possible through reference to objective standards. This trend may encourage Australian courts to adopt the same position. In addition, the taking of a more positive view towards contracts with open terms is in line with the increased reliance of businesses on agreements with open terms in international transactions, a matter which will be welcomed by business people.[78] Management of all aspects of a complicated and lengthy international transaction in one phase of negotiations is often unlikely. Parties need to specify some aspects, leaving others to be decided in the future. Honouring these arrangements is in accord with commercial reality in which business people view these

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74 (1949) 80 CLR 11 at 29; this statement has been quoted with approval in *Hall v Busst* (1960) 104 CLR 206 at 245.

75 In *Biotechnology Australia v Pace* (1988) 15 NSWLR 130 at 136, Kirby J pointed out: "Where there is a readily ascertainable external standard which is proved, the court will have regard to it in order to add flesh to the provision which, on its own, is unacceptably vague and uncertain or apparently illusory." See also: *Chitty on Contracts: General Principles* (Sweet & Maxwell, London, 27th ed 1994) at 136.

76 In *Sudbrook Trading v Eggleton* [1983] 1 AC 444 at 486, Lord Fraser pointed out: "The appropriate means for the court to enforce the present agreements is in my opinion by ordering an inquiry into the fair value of the reversions."

77 In *Money v Ven-Lu-Ree* [1988] 2 NZLR 414 at 417, Cooke P said: "In modern times the Courts have tended in the main to seek to give business efficacy to agreements apparently reached, provided that some standard or machinery can properly be found for supplying what is lacking in the express terms."

78 Finn, "Future Agreements and Uncertainty of Contract" (1989) *New Zealand L J* 206 at 211.

protocols as binding.[79] In response to commercial needs, Article 2.14 of UNIDROIT Principles of International Commercial Contracts reads as follows:

> (1) If the parties intend to conclude a contract, the fact that they intentionally leave a term to be agreed upon in further negotiations or to be determined by a third person does not prevent a contract from coming into existence.
> (2) the existence of the contract is not affected by the fact that subsequently
> (a) the parties reach no agreement on the terms; or
> (b) the third person does not determine the term, provided that there is an alternative means of rendering the term definite that is reasonable in the circumstances, having regard to the intention of the parties.[80]

In Switzerland the authority given to the court to fix undecided terms is broader than that of the Australian legal system. Article 2 of the Swiss *Code of Obligations* says:

> Where the parties have agreed on the essential terms of a contract, the contract is presumed to be binding even though unessential terms have been left open.
> Where no agreement can be reached concerning the unessential terms left open, the court will decide them according to the nature of the transaction.[81]

The *Civil Code* of the Russian Federation also recognises protocols as enforceable contracts provided that they "contain conditions enabling the establishment of the subject, and also the other material conditions, of the principal contract." [82]

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79 Dugdale & Lowe, "Contracts to Contract and Contracts to Negotiate" (1976) *J Business L* 28 at 36.
80 UNIDROIT, *Principles of International Commercial Contracts* (UNIDROIT, Rome, 1994) at 238.
81 Goren, *The Swiss Federal Code of Obligation* (Fred B Rothman, Colorado, USA, 1987) at 1.
82 Article 429 of the Russian Federation *Civil Code* provides:

> 1. Under a preliminary contract the parties shall be obliged to conclude in future a contract concerning the transfer of property, fulfilment of work, or rendering of services (principal contract) on the conditions provided for by the preliminary contract.
> 2. The preliminary contract shall be concluded in the form established for the principal contact, and if the form of the principal contact has not been established, then in writing. The failure to comply with the rules concerning the form of the preliminary contract shall entail its nullity.
> 3. A preliminary contract must contain conditions enabling the establishment of the subject, and also the other material conditions, of the principal contract.
> 4. A preliminary contract shall specify the period in which the parties are obliged to conclude the principal contract.
> If such period has not been determined in the preliminary contract, the principal contact shall be subject to conclusion within a year from the moment of concluding the preliminary contract.
> 5. In instances when a party which has concluded a preliminary contract evades the conclusion of the principal contract, the provisions established by Article 445(4) of the present Code shall apply.
> 6. The obligations provided for by a preliminary contract shall terminate if before the ending of the period in which the parties must conclude the principal contract is has not

It is worth noting that a duty to negotiate in good faith or in accordance with an agreed schedule to reach an agreement can be created by means of the promissory estoppel doctrine, despite the fact that the contract is void or unenforceable. In *Waltons Stores v Maher*,[83] the High Court of Australia extended the doctrine to cases where no pre-existing contractual relationship exists between the parties.[84] The following elements need to be met to apply the doctrine: i) a clear promise must be created that the negotiations will proceed or the contract will be reached;[85] ii) upon reliance on this assumption, the promisee acts (or abstains from acting) which causes a detriment to the promisee;[86] and, iii) unconscionable conduct must exist.[87] When these elements are satisfied, the theory affords protection against the detriment which would flow from withdrawing from the negotiations or escaping

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> been concluded, or one of the parties does not send to the other party an offer to conclude this contract.

Article 445(4) says:

> If a party for which in accordance with the present Code or other laws the conclusion of the contract is obligatory evades to conclusion thereof, the other party shall have the right to apply to a court with a demand to compel the contract to be concluded.

Butler (tr), *Civil Code of the Russian Federation* (Interlist Publishing, London, 1995) at 198 & 208.

83 (1988) 164 CLR 387.

84 Dorney & Grimshaw, "Case Note: Waltons Stores (Interstate) Ltd v Maher" (1988) 11 *UNSW L J* 231; Khoury, "Promissory Estoppel - a Sword Unsheathed" (1990) 64(11) *Law Institute J* 1054. A similar approach has been taken by the New Zealand Court of Appeal in *Burbery Mortgage Finance v Hindsbank* (1989) 1 NZLR 356; see Beck, "Contract" in Borrowdale (ed), *Essays in Commercial Law* (Christchurch, NZ, 1991) at 51.

85 In *China Ocean Shipping v P S Chellaram* (1990) 28 NSWLR 354 at 380, Kirby J said: "In order for there to be a promissory estoppel, it is necessary that the promise should be clear and unequivocal".

86 In *Waltons*, Mason J and Wilson J remarked that:

> equity will come to the relief of a plaintiff who has acted to his detriment on the basis of a basic assumption in relation to which the other party to the transaction has 'played such a part in the adoption of the assumption that it would be unfair or unjust if he were left free to ignore it'. ... Equity comes to the relief of such a plaintiff on the footing that it would be unconscionable conduct on the part of the other party to ignore the assumption.

(1988) 164 CLR 387 at 404.

87 With respect to unconscionability, Mason J and Wilson J added at 406:

> As failure to fulfil a promise does not of itself amount to unconscionable conduct, mere reliance on an executory promise to do something, resulting in the promisee changing his position or suffering detriment, does not bring promissory estoppel into play.

from concluding the contract.[88] For example, if during negotiations one party has expended time, energy or money preparing something at the request of the other party or in accordance with its specifications in expectation of reaching the final agreement, a remedy may be granted based on promissory estoppel if the other party withdraws from negotiations.[89]

In countertrade arrangements the primary contract has been entered into by the initial importer relying on the assurance that the initial exporter will conclude the counter-trade contract. As a result, the liberty to refrain from concluding the counter-trade contract may be limited by means of the promissory estoppel, even if the protocol requiring the initial exporter to enter into the counter-trade contract is considered invalid for some reason. The original importer assumes that a counter-trade contract with its benefits will be entered into, and, upon reliance on this assumption, it has entered into the primary contract or has paid more than market practices for the primary contract. As a result, the original exporter's failure to enter into that contract will occasion detriment to the original importer. If the original importer has entered into the primary contract and shows that it has done so in reliance on the original exporter's promise to enter into the counter-trade contract which causes detriment to it, the court may provide a remedy necessary to avoid the detriment that would otherwise be suffered by the importer.

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88 This new approach in the promissory estoppel doctrine was followed soon after in *Silovi v Barbaro* (1988) 13 NSWLR 466.

89 In *Waltons* the doctrine of estoppel has a general application. This broad application has been supported in *Commonwealth of Australia v Verwayen* (1990) 170 CLR 394 at 412 per Mason CJ. In *China Ocean Shipping v P S Chellaram* (1990) 28 NSWLR 354 at 387, however, Kirby J has cast doubt on availability of promissory estoppel in international commercial transactions. Kirby J said:

> The rules of estoppel, developed by the Courts of Chancery and Common Law in England, and inherited in many major and minor common law jurisdictions, are by no means universal. It may be doubted that they would have an equivalent in the People's Republic of China.

According to this conclusion, estoppel may not be sought by a foreign party whose legal system does not recognise the doctrine of estoppel and who relies on an international convention.

It is to be noted that the legal consequences of equity created by means of estoppel are not similar to those that would have arisen from the protocol, if it had not been invalid. There are differences in legal effect between a valid protocol and an equity created by estoppel. While obligations under a valid protocol are measured by reference to its content and surrounding circumstances, estoppel provides necessary remedy to prevent detriment resulting from reliance on assurance, assumption or unconscionable conduct.[90] Thus, the court may not compel the initial exporter to enter into the counter-trade contract, but rather provides an award for damages to cover the detriment suffered by the initial importer in reliance on a promise to counter-trade.[91]

2.2.4. Closing Remarks

The legal weight of protocols depends on their contents and the governing law. The more details they contain, the greater the possibility of being enforceable. Apart from the content, the applicable law also has a great impact on the legal consequences of protocols. For instance, while consideration is an element of an enforceable protocol in the common law, it is not a requirement in the civil law system. As a result, the parties should draft protocols as completely as possible and choose a law which is more in sympathy with arrangements with open terms. If the protocol is to be governed by Australian law, establishing machinery for settlement of undecided terms is a necessity. This machinery can be an arbitrator who is authorised to fix terms if the parties fail to reach agreement.

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90 *Waltons Stores v Maher* (1988) 164 CLR 387 at 425 per Brennan J.

91 In *Waltons Stores v Maher* (1988) 164 CLR 387 at 423, Brennan J said:

> The object of the equity is not to compel the party bound to fulfil the assumption or expectation; it is to avoid the detriment which, if the assumption or expectation goes unfulfilled, will be suffered by the party who has been induced to act or to abstain from acting thereon.

Moreover, if the protocol is undertaken prior to both primary and counter-trade contracts, it is a precaution to sign both final contracts simultaneously.[92] If a primary contract is entered into concurrent with a protocol which requires the original exporter to counter-trade, the preliminary contract should be drafted as completely as possible to minimise the possibility of unenforceability of the agreement, despite the fact that the promissory estoppel doctrine may be brought into play.

3. Interdependence of Contracts in a Countertrade Package

In countertrade transactions the primary and the counter-trade contracts are connected to each other in one way or another. A question, therefore, arises whether the contracts found in a countertrade package are interdependent. When the contract at issue is part of a merged contract or it has a term linking it to the other, it is presumed that the contracts are interdependent. Where a contract has no reference to other contracts of a countertrade package, the interdependence is uncertain. If there is no valid agreement indicating the linkage of the contract to the others, the contract is prima facie an independent contract, although in negotiation it has been considered as part of the countertrade package. In cases where the contract itself has no linkage but another valid agreement signifies that it is part of a countertrade package, various legal systems may provide different views as to dependence or independence of the contract. Under Austrian law, for example, such transactions may be considered as barter rather than two separate contracts if the parties did not intend to conclude two separate contracts.[93] Similarly the contracts included in a

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92 It is to be noted that if one of the two contracts has been concluded under the protocol it is more likely that a court will ask for the conclusion of the other contract. Carter & Harland, *Contract Law in Australia* (Butterworths, Australia, 3rd ed 1996) at 81.

93 Loeber, "Barter Trade - An Austrian View" in Lafili (ed), *Survey of the International Sale of Goods* (Kluwer, Deventer, the Netherlands, 1986) at 304.

countertrade package are likely to be considered as being legally interdependent in many East European countries.[94]

In the Australian legal system, if it is not evident that the parties have intended to enter into two separate contracts, the contracts may be viewed as legally interdependent. This conclusion may be supported by the fact that in some cases the price of the primary contract is somewhat higher than its market price to compensate the likely loss arising as a result of undertaking counter-trade obligations. Moreover, the original importer has agreed to buy from the exporter in expectation of the obligations undertaken by the exporter in return. As Lord Wilberforce said in *Reardon Smith Line v Yngvar Hansen Tangen*, in a "commercial contract it is certainly right that the court should know the commercial purpose of the contract and this in turn presupposes knowledge of the genesis of the transaction, the background, the context, the market in which the parties are operating".[95] The commercial purpose of choosing countertrade is to link the primary contract to the counter-trade contract which can supplement the contractual provisions of the primary contract, making it dependent on the other contracts of the package.

If the primary contract is found dependent, any failure to fulfil the obligations undertaken in the counter-trade contract authorises the initial importer to terminate the primary contract or to suspend its own performance if the failure is sufficiently significant. In *State Trading Corporation v Golodetz*, Golodetz sold a cargo of sugar to the buyer, provided that the seller counter-purchased goods up to 60% in value of the sugar at some time during the six

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94 Silverman, "New Thinking: Current Aspects of East-West Countertrade" (1990) 3 *Annual Conference on Intellectual Property* 4 at 4-20.

95 [1976] 1 WLR 989 at 995; see also *Codelfa Construction v State Rail Authority of NSW* (1982) 149 CLR 337 at 350-357.

months period following the date of contract.[96] As regards the counter-trade commitment, the seller was to give 3% performance bond guarantee within seven days of the date of the contract. Since the seller failed to give such guarantee, the buyer argued that its failure to open a letter of credit was excused because its obligation was conditioned on opening the counter-trade guarantee. This argument was rejected by the court on the basis that the seller's obligation to open the guarantee was not a condition of the contract. Lord Justice Kerr pointed out: "I can see no basis for treating the sellers' failure to open the counter-trade PBG within seven days as a breach which went to the roots of the contract".[97] In this case, although the interdependence of all agreements was acknowledged, opening the counter-trade guarantee was not considered to be sufficiently significant to place the whole transaction at risk.

Since it is not clear in some cases whether courts view contracts undertaken under a countertrade scheme as interdependent or independent, the parties should include clear provisions into the contracts specifying whether or not they should be considered interdependent.[98] In the case of a breach, the kind of remedy available for the aggrieved party, such as damages or the right to terminate the other contract or suspend performance of the obligations, should also be specified. Even if a merged contract is chosen, it is prudent to signify the issue of interdependence clearly by indicating that the performance of

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96 [1989] 2 Lloyd's L R 277.

97 At 284.

98 Under a countertrade arrangement, a German steel company delivering a turnkey plant to Iran committed itself to counter-trade crude oil from Iran at a fixed price. Subsequently, the German company transferred its commitment to a Belgian oil company at a discount received from the German company. Due to the 1978 instability in Iran, the turnkey contract was suspended while a certain quantity of the oil had been purchased by the Belgian company. The German company refused to pay the discount on the grounds that the counter-trade was also cancelled owing to the cancellation of the turnkey contract. Both trial and appeal courts in Germany held that the primary contract and counter-trade contract were independent from each other if nothing is provided in the contract indicating a contrary intention. Guyot, "Countertrade Contracts in International Business" (1986) 20 *International Lawyer* 921 at 939-941.

each side is conditional on the other's. It should be noted that even in merged contracts, the parties can clearly provide that the obligations in each direction should be viewed as being legally independent from other obligations.[99]

Conclusion

The distinguishing feature of countertrade transactions is the legal connection between different contracts included in a countertrade package. The structure chosen for the transaction should address the issue of linkage. The primary contract is often drafted independently without a term connecting it to the counter-trade contract. The issue of linkage and the specifications of the counter-trade to be concluded later are generally spelt out in a preliminary agreement known as a protocol. These protocols may be viewed in some legal systems as too vague and uncertain to give rise to a legal contract. The parties, therefore, need to draft the protocol more precisely or provide some machinery for the determination of those terms left for later agreement to avoid the problem of unenforceability. The counter-trade contract is often drafted subsequently in accordance with the terms of the protocol. When a contract which has no linking reference to the other contracts is connected to the others by a third contract, such as a protocol, a court may view all contracts as legally interdependent. To avoid such interdependence, the parties should make clear that a particular contract is independent from the others. Apart from the issue of linkage, the contents of the individual contracts of a countertrade package need to be shaped in line with their reciprocal character. The next two chapters will deal with major provisions which should be contained in these contracts.

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99 Silverman, "New Thinking: Current Aspects of East-West Countertrade" (1990) 3 *Annual Conference on Intellectual Property* 4 at 4-21.

CHAPTER 8

Counterpurchase, Advance-purchase and Debt-for-export Swaps

Introduction

In many cases of countertrade, an exporting party is required to counter-purchase some unrelated products from the importing party.[1] The exporting party has to undertake a counter-purchase obligation either to pave the way for its own exports or to obtain the price of an export which has already been made. The counter-purchase obligation may be undertaken in three different situations: i) the exporting company sells certain products and agrees in return to counter-purchase some products from the importing party; ii) the exporting company purchases in advance certain products from the importing party to remove the obstacles existing in the way of its own exports; and iii) after an export contract has been concluded outside a countertrade scheme, the exporting party counter-purchases some products from the importing party who cannot meet its payment obligations. These three situations are discussed here in three sections: counterpurchase, advance-purchase and debt-for-export swaps.

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1 When the goods to be purchased back are related to the goods exported under the primary contract, the transaction is buy-back. See Chapter 1, pages 26-27.

1. Counterpurchase

Counterpurchase is a reciprocal transaction under which an exporting party sells certain products to an importing party for cash and undertakes in return to purchase some products from the importing party. These two sales contracts, made in two directions, are connected legally to each other. Under the first sales contract, the exporting party sells or agrees to sell certain goods or services to the importing party for cash. For the sake of clarity, I shall call this export sales contract the *primary sale*, the exporter the *original seller* and the importer the *original buyer*. Under the second sales contract, the original seller purchases or agrees to purchase in return certain products from the original buyer for cash. This contract is known as the *counter-purchase contract* (with hyphen). The whole arrangement covering the primary sale and the counter-purchase contract is known as *counterpurchase* (without hyphen).

Under a typical counterpurchase scheme, the primary sale is a conventional international sale of goods contract and consequently has no peculiarity to be discussed here. The distinguishing element of counterpurchase lies in the undertaking of a counter-purchase obligation which may be spelled out in a protocol or in the counter-purchase contract itself. The parties may have to agree broadly on the terms of contract, leaving the details for future agreements because at the time of concluding the contract the details are not determined. Since subsequent disagreement over the details may result in serious problems, the contract should cover the most important issues of counter-purchasing. If it is impracticable to specify the details, a mechanism should be established in the contract to deal with the unsettled issues. The focus of this section, therefore, is on the key issues which should be considered in the drafting of a counter-purchase obligation. These issues include a commitment to counter-purchase, the products to be counter-purchased, the pricing mechanism, the performance time, the concluding of definitive contracts, penalty, transferability and assignment, and marketing restrictions on the resale process.

1.1. The Counterpurchase Commitment

The central core of a counterpurchase transaction is an undertaking by the original exporter to counter-purchase goods from the original importer. The request for a counter-purchase commitment is generally raised by the original buyer at some stage of negotiations as a condition for the conclusion of the primary sales contract. The kind of commitment to be carried out by the original seller should be clarified during the negotiations. Typically the original seller undertakes a definitive commitment to counter-purchase certain goods from the original buyer. In some cases, however, the original seller may agree to negotiate in good faith to reach a counter-purchase contract, to find someone to counter-purchase certain products, or to provide some assistance to the original buyer to market its products abroad.

The kind of obligation to be undertaken by the original seller should be clearly fixed. If a definitive counter-purchase commitment is to be undertaken, the contract should contain a firm commitment from the original seller to counter-purchase certain products during a set period of time. The original buyer also needs to clearly commit itself to sell the agreed products. If the supplier of the goods to be counter-purchased is a third company, a commitment by the supplier, or an assurance given by the original buyer that the goods will be available for sale, also needs to be made. In cases where the original seller's commitment is making the best efforts to reach a counter-purchase contract, furthering the negotiations in good faith, providing some marketing assistance, or finding someone to counter-purchase, sufficient care should be taken in drafting these arrangements if an enforceable commitment is expected. Courts usually refuse to enforce a vague commitment "where the language used is so obscure and incapable of any precise or definite meaning that the court is unable to attribute to the parties any particular contractual intention".[2]

The amount of the goods to be counter-purchased is a sensitive issue during negotiations. The amount is generally a percentage of the value of the primary sales contract. From the standpoint of Western exporters one of the difficulties associated with counterpurchase is that the ratio requested by the importing parties is often high.[3] This ratio is generally a matter of negotiation[4] which ranges from ten to one hundred percent of the primary sale value, depending on the type of goods to be imported under the primary sales contract, the relevant sector, the country which is making the demands, the goods to be counter-purchased, and other circumstances.[5]

1.2. The Nature and Quality of Products to be Counter-purchased

The success of a counterpurchase transaction depends greatly on the counter-purchased products and their quality.[6] The most preferred products for an original exporter are those

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2 *Thorby v Goldberg* (1964) 112 CLR 597 at 607; see also Chapter 7, pages 283-297.

3 *International Trade Finance* (May 18, 1989) Section: Finance/Business; available in Lexis-Nexis, News Library.

4 In some cases the ratio has been fixed by a government and is not open to negotiations. For example, this ratio has been fixed as 100 percent in Indonesia for government procurement contracts of over $750,000. 6(9) *East Asian Executive Reports* (September 15, 1984) at 9.

5 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 37-39.

6 Mishkin, "Countertrade I" (1989) *International Business Lawyer* 402 at 403.

which can be used for in-house consumption or are disposable through its marketing network, subsidiaries or subcontractors.[7] A second alternative is often raw materials, oil, commodities, chemicals and semi-processed materials while the least desirable goods are manufactured and finished ones.[8] On the other hand, the original importers often insist on those goods produced in their own plants or which are readily available for export. These goods may not be easily marketable because they are poor in quality or they suffer from a non-established or saturated market. Selling or purchasing the most desirable goods is a matter of negotiation strength and marketing skills.

In cases where the type of goods to be counter-purchased is known to the parties at the time of drafting the counter-purchase obligation, such as oil or wheat, the parties should specify the details as clearly as possible. Since the type of goods is known, the parties have a greater chance to specify precisely the features of the goods such as quality, merchantability, fitness for purposes, appearance, packaging, and the like. These products may be either existing goods owned or possessed by the original importer or those to be produced, manufactured or acquired subsequently. It is to be noted that when the type of goods is determined in the contract, there is greater possibility that the Vienna Sales Convention applies to the contract.[9]

However, in many cases of counterpurchase it is either impracticable or undesirable at the time of concluding the contract to specify the exact type of goods. In particular, when a

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7 Using the products for internal use or ability to resell them through its affiliated companies causes little or no additional costs when compared to reselling the products through traders. Grabow, "Negotiating and Drafting Contracts in International Barter and Countertrade Transactions" (1984) 9 *North Carolina J International L & Commercial Regulation* 255 at 262.

8 McVey, "Countertrade and Barter: Alternative Trade Finance by Third World Nations" (1980) 6 *International Trade L J* 197 at 209.

9 Article 14(1) of the Convention says: "A proposal is sufficiently definite if it indicates the goods". See Chapter 5, pages 182-184.

government requires the exporting companies to meet a counter-purchase commitment, the kind of goods to be counter-purchased is not often specified. The original exporter may also not want to restrict itself to a specific kind of product, especially when finished products are involved. The more extensive the range of products included, the greater the chance for the counter-purchaser to select more marketable products. In these circumstances either an exhaustive list of goods is presented from within which the goods are to be counter-purchased or some general features of products are given within the limits of which the goods are to be chosen.

When the products need to be chosen from within a list, a commitment from the original exporter should be inserted into the contract requiring the exporter to counter-purchase goods from within the list which is usually attached to the contract. It should also be clear in the contract whether the original exporter can choose more than one product or the exporter has to select only one of the products listed.[10] In some cases, particularly when the list has not been prepared exclusively for the deal in question, the list may be outdated and some products listed are not available for export. Thus, it is important to assure their availability before concluding the contract, or to make a binding obligation on the original importer in respect of availability of the goods listed. It is also possible that the list attached is not exhaustive but rather a guideline for the range of products permitted to be counter-purchased.

Where a broad specification of goods is agreed on, the original exporter has an extensive choice of alternative products within that coverage. The contract may specify that all goods produced in a given region or by certain companies are possible to be counter-purchased.

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10 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 43.

They may restrict the choice to a sector such as industrial finished products, agricultural commodities, or minerals. Sometimes, a list of those goods not permitted to be counter-purchased is attached to the contract.

Attaching a list of products into the contract or providing a broad specification of the goods may be viewed in some legal systems as too uncertain to give rise to an enforceable contract. As previously stated, this kind of contract may be viewed as too vague to be enforceable in Australian law.[11] It is, therefore, prudent to describe the goods as fully as possible or to establish a procedure for selecting the goods and a mechanism for solving problems if any disagreement occurs.

There are some other issues to be borne in mind in selecting appropriate goods for counter-purchasing. Under the export-import regulations of the original importer's country (the exporter of counter-purchased goods), certain products may not be permitted to be exported at all or not under reciprocal schemes.[12] At times the products available for the counter-purchase are grouped in accordance with the priority of the products imported under the primary sales contract. For example, minerals or other easily marketable products may be made available only where high-priority Western goods are imported under the primary sales contract.[13] The available products may be limited to those originating within

11 See Chapter 7, pages 283-297.

12 Almost all countries which mandate countertrade impose certain restrictions on those products permitted to be counter-purchased. Otherwise, the easily marketable products are counter-purchased which the country mandating countertrade often has no difficulty in converting into hard currency at the world marketplace and consequently there is no rationale for the country to mandate countertrade. Commonwealth Secretariat, *Countertrade: Guidelines for Developing Countries* (Commonwealth Secretariat, London, 1988) at 28.

13 Verzariu, *Countertrade, Barter, and Offsets* (McGraw-Hill Book Company, New York, 1985) at 73.

the country[14] or in a specific region,[15] or meeting a particular level of quality and standards.[16] In these circumstances, the exporting party may require the counter-exporters to obtain permission before exporting, ensuring that relevant regulations are complied with in respect of particular categories of goods. It is, therefore, important to ensure before concluding the contract that the given products are free from any export obstacles and that obtaining an export licence for them is possible.

The destination market may also have certain regulations in respect of the goods imported into the country which may affect the success of a counterpurchase arrangement. Importing some products from certain countries may attract a higher level of duties and tariffs when compared to those imported from other countries. For example a higher lever of tariff may be imposed by the WTO members countries on those products imported from the non-members.[17] Even among the contracting parties, certain products may receive a higher level of tariff because of anti-dumping or countervailing duties imposed in the destination market in response to selling the products at a price below that charged in the home market or the subsidies granted for those products.[18]

Furthermore, it is necessary to ensure that the goods meet the necessary levels of quality, purity, technical efficiency and fitness for the purposes required in the destination market in

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14 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 53.

15 For example, those products which are produced in a free trade zone.

16 Such a requirement may be imposed by the exporting country to maintain its own reputation in the international marketplace.

17 One of the key purposes of the WTO (previously the GATT) has been the reduction of tariffs and extending the tariff concession to all members. The members have no commitment to deal equally with the goods imported from non-members. Jackson & Davey, *Legal Problems of International Economic Relations* (West Publishing Co, USA, 2nd ed 1986) at 395.

18 For a comparative study of anti-dumping measures see generally Steele (ed), *Anti-Dumping under the WTO: A Comparative Review* (Kluwer Law, London, 1996), specially Moulis, "Australia" at 35-71.

connection with safety, health, environment, national security and so on. In cases where the type of the goods is not identified, the parties need to specify these requirements in a general way. If the counter-purchaser does not know enough about the goods to give the exact specification, it may describe the goods broadly by providing the purposes for which the goods are to be counter-purchased, such as for consumption in a particular country. The contract may provide that the products must meet the standards established in that particular sector, be fit for the purposes expected from such goods, be packaged in a way usually used for these kinds of goods, or comply with the requirements imposed in the destination country.[19] By virtue of Article 35 of the Vienna Sales Convention, these requirements are presumed for goods sold under the Convention even if the parties have not explicitly stated this in the contract.[20]

The original exporter may provide some assistance to the supplier in this respect by helping the original buyer to improve the quality, design, appearance and packaging of the products in order to reach the world market standards necessary for their marketability. For

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19 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 59.

20 Article 35 of the Convention provides:

> (1) The seller must deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract.
> (2) Except where the parties have agreed otherwise, the goods do not conform with the contract unless they:
> (a) are fit for the purposes for which goods of the same description would ordinarily be used;
> (b) are fit for any particular purpose expressly or impliedly made known to the seller at the time of the conclusion of the contract, except where the circumstances show that the buyer did not rely, or that it was unreasonable for him to rely, on the seller's skill and judgement;
> (c) possess the qualities of goods which the seller has held out to the buyer as a sample or model;
> (d) are contained or packaged in the manner usual for such goods or, where there is no such manner, in a manner adequate to preserve and protect the goods.
> (3) The seller is not liable under subparagraphs (a) to (d) of the preceding paragraph for any lack of conformity of the goods if at the time of the conclusion of the contract the buyer knew or could not have been unaware of such lack of conformity.

example, under a counterpurchase agreement which required General Electric to counter-purchase trailers from Greece, General Electric helped the Greek producer to redesign its trailers to be suitable for US consumption.[21] Alternatively, the parties may establish a procedure to control and check the quality and other aspects of the goods before the ultimate sale contracts are concluded. Similarly, the parties may agree that a pre-shipment inspection should be carried out to ensure that the goods are consistent with the specifications indicated in the contract. The contract may go further, specifying the details of the inspection procedure in respect of the time-frame, place, inspectors, confidentiality of reports and binding character of the inspector's determination.[22] If a procedure for inspection is agreed on, the parties should determine the remedy for non-conformity. They may agree that non-conformity entitles the counter-purchaser to be released from its counter-purchase commitment in whole or in part, to reduce the price accordingly, or to require delivery of substitute goods.

1.3. Quantity of the Goods

The quantity of the goods to be counter-purchased is another key issue which needs to be agreed. The amount of the goods may be designated in terms of an exact quantity, a compensation ratio or fixed monetary terms. Agreement on the exact quantity of the goods is possible where the nature of the goods is definitive at the time of the conclusion of the contract. The exact quantity of the goods may be accomplished by reference to units, weight or other measures. By specifying the exact quantity of the goods, the counter-

21 Mishkin, "Countertrade and Barter: The Basic Legal Structure" (1986) 14 *International Business Lawyer* 7 at 10.

22 Rubin, *The Business Manager's: Guide to Barter, Offset and Countertrade* (The Economist Intelligence Unit, London, 1986) at 18.

purchaser undertakes to counter-purchase that quantity, irrespective of the amount and value of the primary sales contract.

Since in many cases of counterpurchase the nature of the goods is not definitive at the time of entering into the contract, the parties may need to address the issue of quantity in a broad sense. A valid contract may be open as to quantity if the quantity can be reasonably determined in the course of performance. Under Article 14 of the Vienna Sales Convention, quantity can be open if the parties make provision for its determination.[23] Quantity is reasonably determinable when some objective standards (or independent circumstances[24]) are referred to, a mechanism has been set up for its determination, or a prior course of dealing or a particular trade usage exists.[25] The sale of total products manufactured in a particular plant, the whole crops grown in a piece of land, or the goods the seller possesses in a warehouse is valid because the quantity is ascertainable by reference to objective standards.

When specifying the exact quantity of goods is impracticable, the parties may agree on the amount of goods as a ratio of the value of the primary sales contract. In these cases, a clarification of how to measure the values of both primary sale and counter-purchase contracts is to be agreed. For example, if the counter-purchase ratio is expressed as 70 percent of the primary sale price, it is important to know whether or not FOB, CFR or CIF values are concerned.[26] The counter-purchaser may also wish to link the ratio to the value

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23 Article 14(1) of the Convention reads: "A proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for determining the quantity".

24 67 *American Jurisprudence* 2d at 567.

25 Howard, "Open Terms as to Quantity in Contracts for the Sale of Goods" (1977) 5(3) *University of Tasmania L Rev* 308 at 310.

26 Under INCOTERMS 1990, in Free On Board (FOB) the buyer has to pay "all costs relating to the goods from the time they have passed the ship's rail at the named port of shipment". In Cost and Freight (CFR), the seller has the obligation to pay all costs relating to the goods until they have been delivered as agreed plus the cost of freight. In Cost, Insurance and Freight (CIF) the seller

of its actual exports in order to reduce accordingly its counter-purchase commitment if for whatever reason the original buyer does not purchase the total amount of products undertaken under the primary sales contract. In these circumstances, the exact amount of goods to be counter-purchased will be determined when the primary sales contract is entered into or fulfilled.

Another alternative open to the parties is to determine the quantity of goods in terms of a fixed monetary amount such as one million dollars. This method has less frequently been used compared to the percentage formula because the original exporter prefers to link the amount of the counter-purchase commitment to its export value rather than to undertake a fixed counter-purchase commitment irrespective of its own export volume.[27] In both alternatives, the number of units which will eventually be counter-purchased depends on the price of each unit which may rise or fall during the life of the contract.

The contract sometimes provides a maximum or minimum amount of goods to be counter-purchased. For example, the original exporter may be required to counter-purchase an amount of not less than 50,000 and not more than 60,000 units. This kind of term may result in different interpretations. For example, the option may be construed in favour of the purchaser which implies that although the supplier has to provide up to 60,000 units if purchaser wishes, the purchaser's obligation to buy is limited to 50,000 units.[28] The option may also be construed in favour of the supplier, providing it flexibility as to the deficiency of or excess in quantity which may take place in performance of the contract. It is, therefore,

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has also to pay the cost of insurance. ICC, *INCOTERMS 1990*, (ICC Publication No 460, Paris, 1990). Since the costs borne by the seller are different in these trade arrangements, the value of the contract is usually more in CIF than FOB.

27 Hober, "Countertrade: Negotiating the Terms" (March 1987) *International Financial L Rev* 28 at 30.

28 67 *American Jurisprudence* 2d at 564.

wise to make it clear if the parties wish to give latitude to the quantity of the goods to avoid a contractual breach in the case of a slight variation in quantity.

1.4. Price of the Goods

Another issue upon which the parties should agree is the price of the goods to be counter-purchased. Three pricing situations should be distinguished: first, the price is fixed for the goods in terms of a given currency; second, the price is left open to be determined later in accordance with a mechanism set up by the parties; and third, the price is not fixed in the contract and no arrangement has been made for its determination.

If the goods to be counter-purchased are specified at the time of concluding the contract, the price is often fixed in terms of a given currency. By fixing the price, the parties achieve a security and certainty in planning their business, although they take the risk of fluctuating market price if there is a gap between the time of undertaking the counter-purchase obligations and the time of performance. For example, Syrian phosphate was once counter-purchased by Western firms at 60 percent higher than its market price at the time of performance because the price had been fixed before the world market price of phosphate dropped.[29] Another risk in fixing the price is the fluctuation of the currency value over the life of the contract. In *North Ocean Shipping v Hyundai Construction*, for example, the price was fixed in US dollars.[30] Prior to payment of the whole price, the US dollar was devalued by 10 percent. It was found by the court that there was no ground for the increase

29 Mishkin, "Countertrade and Barter: The Basic Legal Structure" (1986) 14 *International Business Lawyer* 7 at 10.

30 [1979] QB 705.

of 10 percent requested by the seller on the basis that the price was fixed, and the promise made to pay 10 percent extra was void for lack of consideration.[31]

The parties may wish to take precautions against the fluctuation of either the price or the currency by providing a mechanism for adjusting the price accordingly, especially if the counter-purchase contract is to be fulfilled over a long period of time. One effective way is to provide an automatic adjustment system which adjusts the price or the currency value in accordance with the inflation rate or by reference to an index without being subject to further negotiations.[32] If such a mechanism for the price adjustment is absent from the contract, the courts may not enforce any adjustment of price, despite the claim of an unanticipated event or harshness.[33]

In many cases of counterpurchase, however, the price may not be fixed at the time of concluding the contract. There are a variety of reasons why the parties leave the price unfixed. One reason is that fixing the price is generally impracticable when the exact type and nature of the goods is not determined at the time of entering into the contract. Second, the market may be too unstable at the time of the conclusion of the contract to fix the price. Third, there are often some gaps between the time of concluding the counterpurchase contract and the definitive counter-purchase contracts. The parties may defer fixing the price to secure themselves against fluctuations in either the market price or the currency value. Fourth, leaving the price for later determination gives more flexibility as to assigning the counter-purchase commitment to a third party, because the assignee may also want to

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31 At 712.

32 See Chapter 9, page 394.

33 Schwartz, "Sales Law and Inflations" (1976) 50 *Southern California L Rev* 1 at 24-25. Further discussion of this respect will come in the Chapter 9, pages 388ff.

engage in price negotiations.[34] Fifth, it is customary that the price in the sale of certain goods is open to be fixed later, such as fuel, coal, fertiliser, citrus fruit, potatoes and so on.[35]

When the price is left open, the parties may provide machinery for the later determination. Under the Australian legal system a valid and enforceable contract may be made although the price is left to be fixed later provided that a mechanism is set up for its determination,[36] or a previous course of dealing exists between the parties as to setting the price. The mechanism can be a reference to ascertainable standards or to objective criteria, such as a fair market price, a particular quotation if an established market exists for the products, or a specific percentage below the market value of the goods.[37] If the machinery agreed on by the parties breaks down, the court may fix the price,[38] by treating "the machinery merely as a means of ascertaining what is capable of being ascertained objectively as a fair and reasonable" price.[39]

If the price is to be calculated according to a formula, one element of which is the cost incurred (eg costs plus a specific percentage), the contract is enforceable even if some

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34 Commonwealth Secretariat, *Countertrade: Guidelines for Developing Countries* (Commonwealth Secretariat, London, 1988) at 48.

35 Murray, "The 'Open Price' Sale of Goods Contract in a Worldwide Setting" (1984) *Commercial L J* 491 at 491.

36 Sutton, *Sales and Consumer Law* (LBC Information Services, Sydney, 4th ed 1995) at 162.

37 A reference to *competitive prices* may cause problems when there is no established price for the products. OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 49.

38 In *Booker Industries v Wilson Parking* (1982) 149 CLR 600 at 613, Brennan J said:

> If the court were able to fix a price in the event of the contractual machinery failing, there would be no uncertainty in the contract and no obstacle in the way of specific performance. The court, being able eventually to fix the price itself if it should be necessary to do so, would so mould its decree of specific performance as to require the parties to do what was reasonably required of them to make their contractual machinery work and, if that machinery should nevertheless fail, the court would itself fix the price. But that course cannot be taken if the parties intend that the price should be fixed exclusively by their contractual machinery.

39 *Booker Industries v Wilson Parking* (1982) 149 CLR 600 at 616, per Brennan J.

disagreement occurs as to the real costs. In *Upper Hunter County District Council v Australian Chilling And Freezing*, Barwick CJ said:

> A contract to build a bridge at cost could not, in my opinion, be held void for uncertainty: it could not properly, in my opinion, be said to be meaningless: nor is it, in my opinion, ambiguous. Endless might be the arguments pro and con as to whether or not in marginal cases some item of expenditure is as claimed a cost, or as to how much of an expenditure is a cost, of the particular activity. But to my mind, generally speaking, the concept of a cost of doing something is certain in the sense that it provides a criterion by reference to which the rights of the parties may ultimately and logically be worked out, if not by the parties then by the courts. There are no elements in the circumstances of this contract to deprive the concept of that certainty.[40]

If the price is left open without setting up a mechanism for its determination and in the absence of an established course of dealing between the parties as to setting the price, various legal systems may provide different views as regards the enforceability of these kinds of contracts.[41] As far as the Australian legal system is concerned, if the contract falls under the coverage of one of the *Sale of Goods Act*, which is in force in different States or Territories of Australia, the contract is valid even if the price is totally unmentioned. In South Australia, for example, s8 of the *Sale of Goods Act* 1895 (SA) reads:

> 1) The price in a contract of sale may be fixed by the contract, or may be left to be fixed in manner thereby agreed, or may be determined by the course of dealing between the parties.
> 2) Where the price is not determined in accordance with the forgoing provisions, the buyer must pay a reasonable price. What is a reasonable price is a question of fact dependent on the circumstances of each particular case.[42]

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40 (1968) 118 CLR 429 at 437; see also: *Trawl Industries of Australia v Effem Foods* (1992) 27 NSWLR 326.

41 Amato, "UN Convention on Contracts for the International Sale of Goods - the Open Price Term and Uniform Application" (1993) 13(1) *J L & Commerce* 1 at 18-21.

42 Similar provisions are effective in other States or Territories as follows:
Sale of Goods Act 1923 (NSW), s 13;
Sale of Goods Act 1954 (ACT), s 13;
Sale of Goods Act 1972 (NT), s 13;
Sale of Goods Act 1896 (Qld), s 11;
Sale of Goods Act 1896 (Tas), s 13;
Goods Act 1958 (VIC), s 13; and,
Sale of Goods Act 1895 (WA), s 8.

As a result, if the *Sale of Goods Act* applies to the contract, the buyer has to pay a reasonable price which will be determined on a case-by-case basis if the price is left completely unsettled.

Similarly, if the governing law of the contract is the Vienna Sales Convention, the contract is valid even if the price term is totally absent from the contract.[43] Despite Article 14(1) which requires the parties either to fix the price or to make provisions for its determination, Article 55 provides solutions to cases where neither way is taken by the parties.[44] Article 55 of the Convention states:

> Where a contract has been validly concluded but does not expressly or implicitly fix or make provision for determining the price, the parties are considered, in the absence of any indication to the contrary, to have impliedly made reference to the price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances in the trade concerned.

Thus, if the contract is perceived as a sale contract within the Convention, the price will be calculated by reference to the price generally charged at the time of entering into the contract.

If the contract is not within the coverage of either the *Sale of Goods Act* or the Vienna Sales Convention, it may be unenforceable in Australia when the parties fail to fix the price or to provide machinery for its determination, unless the applicable law of the contract is a

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43 Honnold, *Uniform Law for International* Sales (Kluwer, Deventer, the Netherlands, 2nd ed 1991) at 137-138.

44 Some commentators, however, contend that Article 55 operates only if a valid contract has already been concluded. To conclude a valid contract, the offer must be sufficiently definitive. As regards the price, an offer is sufficiently definitive if it expressly or implicitly fixes or makes provisions for determining the price. These commentators conclude that under the Convention, the price needs to be determined or a mechanism for its determination needs to be included in the contract. Farnsworth, "Formation of Contract" in Galston & Smit (ed), *International Sales* (Matthew Bender & Company, USA, 1984) at 3-8 & 3-9. The Hungarian Supreme Court in *Pratt & Whitney v Malev Hungarian Airlines* decided that an offer without addressing the price is not sufficiently definitive. Amato, "UN Convention on Contracts for the International Sale of Goods - the Open Price Term and Uniform Application" (1993) 13(1) *J L & Commerce* 1 at 1.

law other than of Australia which recognises contracts having no arrangement as to the price.[45]

Irrespective of the method chosen in relation to the price, the parties may agree on a most-favoured-customer term which grants the counter-purchaser the same advantages granted by the supplier to other purchasers in a given territory or world-wide.[46] This term is generally included to ensure that the same products will not be sold at a lower price to a third party. If similar products are sold at a lower price, the parties may provide that the price of the counter-purchased goods will automatically be reduced to that lower price, irrespective of what was agreed upon in the contract. The contract should also clearly state whether the price covers the costs of insurance and transportation which are elaborately set forth in INCOTERMS such as CIF, FOB or FAS.[47] Although counter-purchasing goods at a lower price is advantageous to cover the risks and costs associated with disposing of them, it is a concern that such low price goods may attract an extra duty as a result of implementing anti-dumping regulations in a given destination market.[48]

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45 For example, if the counterpurchase contract is governed by the UNIDROIT Principles of International Commercial Contracts, Article 5.7 will apply which provides:

> (1) Where a contract does not fix or make provision for determining the price, the parties are considered, in the absence of any indication to the contrary, to have made reference to the price generally charged at the time of the conclusion of the contract for such performance in comparable circumstances in the trade concerned or, if no such price is available, to a reasonable price.
> (2) Where the price is to be determined by one party and that determination is manifestly unreasonable, a reasonable price shall be substituted notwithstanding any contract term to the contrary.
> (3) Where the price is to be fixed by a third person, and that person cannot or will not do so, the price shall be a reasonable price.
> (4) Where the price is to be fixed by reference to factors which do not exist or have ceased to exist or to be accessible, the nearest equivalent factor shall be treated as a substitute.

46 Grabow, "Negotiating and Drafting Contracts in International Barter and Countertrade Transactions" (1984) 9 *North Carolina J International L & Commercial Regulation* 255 at 266.

47 ICC, *INCOTERMS 1990*, (ICC Publication No 460, Paris, 1990).

48 See generally Fisher, "The Antidumping Law of the United States: A Legal and Economic Analysis" (1973) 5 *L & Policy International Business* 85.

1.5. Time Period

A period of time is usually agreed on within which the original exporter has the option to fulfil its counter-purchase obligation. The original exporter's demand is generally for a longer period to have more time to select appropriate goods at the right time. On the other hand, the supplying party often wishes a shorter period to get access to hard currency earlier. The time period stipulation may provide two alternatives: first, the original exporter has an option to fulfil its counter-purchase commitment over that period any time it wishes; and second, the original exporter has to fulfil its commitment during that limit but in accordance with a schedule agreed by the parties.[49]

In the first alternative, the original exporter has an option to perform its commitment at any time during that period. This period often ranges from one to three years[50] which may begin at a specific time such as three months after concluding the counterpurchase contract. In fixing the period, the parties should consider the availability of the goods and the time taken to select appropriate goods, to get export licences, and to arrange for transportation, insurance, inspection of goods and the like. The parties may arrange that the period will be extended if some specific difficulties, such as unavailability of the goods or frustration, arise. Moreover, it should be made clear whether the original exporter may split the performance or it must fulfil its entire commitment at once but during the agreed period.

In the second alternative, the commitment to counter-purchase has to be fulfilled gradually in accordance with a schedule during a time period provided in the contract. The parties

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49 Guyot, "Countertrade Contracts in International Business" (1986) 20 *International Lawyer* 921 at 931

50 McVey, "Countertrade and Barter: Alternative Trade Finance by Third World Nations" (1980) 6 *International Trade L J* 197 at 209.

may agree, for example, that at least a quarter of the obligation should be performed every six months during a period of two years. The unavailability of goods and difficulties in disposing of them are two main reasons which justify the resort to such schedules. The supplier who has difficulties in making all the goods available during a short period of time prefers to supply them under a schedule gradually. The counter-purchasers may also prefer to counter-purchase the goods gradually to be able to dispose of them without saturating thc market. Moreover, when a large quantity of goods are loaded in a market at once, there is an increased possibility that the imported goods may cause a substantial injury to the destination domestic industry which may result in the application of protective measures such as imposing extra tariffs or other anti-dumping measures.[51]

1.6. Conclusion of Definitive Counter-Purchase Contracts

Since in many cases of counterpurchase, the parties outline the major issues of the counter-purchase contracts to be entered into subsequently in a protocol, a procedure should be established for their conclusion. These counter-purchase contracts, which are conventional sales, must be drafted in accordance with the issues outlined and within the time frame agreed upon. Like other contracts, these contracts come into existence by an offer made by one party and accepted by the other. As a result, the protocol may specify which party has to or has a right to make an offer. The protocol may also address issues related to the formation of the counter-purchase contracts, such as what constitutes an offer,

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51 Article VI of the GATT 1994 authorises contracting parties to impose extra duties to those products dumped in their markets if they cause or threaten material injury to their established industries. In accordance with Article 3.1 of the *Agreement on Implementation of Article VI of the GATT 1994,* the volume of the dumped imports is a key factor for determination of injury for taking anti-dumping measures. *The Result of the Uruguay Round of Multilateral Trade Negotiations: the Legal Texts*, (WTO, Geneva, 1995) at 172.

irrevocability of offers, the time and place the contract comes into existence, and the time period for acceptance or rejection. For example, the protocol may specify that an offer which "contains additional or different terms which do not materially alter the terms of the offer constitutes an acceptance, unless the offeror, without undue delay, objects orally to the discrepancy or dispatches a notice to that effect".[52] The protocol may also provide that either party should not unreasonably reject an offer made by the other and both parties should make a joint effort to reach definitive counter-purchase contracts.[53]

1.7. Liquidated Damages and Penalty Clauses

The protocol should contain an agreement on a specified sum for cases where the original exporter fails to counter-purchase or delays in performance.[54] By including such a term, the parties may want to estimate and fix in advance the damages resulting from contract breaches. Stipulating an agreed sum is useful especially in cases where the cost of determining the loss suffered by the aggrieved party is high when compared to any likely recovery, or where proving a financial loss is difficult.[55] As a result, agreement on a fixed sum creates certainty as to consequences of the breach. It is significant to the parties to an international transaction to determine the consequences of any likely breach.

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52 Article 19(2) of the Vienna Sales Convention.

53 ECE, *International Counterpurchase Contracts* (UN, New York, 1990) at 9.

54 In a sample counter-purchase agreement drawn up by the Ministry of Trade and Industry of Malaysia, the agreement has no stipulation in regard to the penalty clause. This sample agreement has been reprinted in: Rubin, *The Business Manager's: Guide to Barter, Offset and Countertrade* (The Economist Intelligence Unit, London, 1986) at 97-102.

55 In *Robophone Facilities v Blank* [1966] 3 All ER 128 at 142, Lord Diplock said:

> It is good business sense that parties to a contract should know what will be the financial consequences to them of a breach on their part, for circumstances may arise when further performance of the contract may involve them in loss. And the more difficult it is likely to prove and assess the loss which a party will suffer in the event of breach, the greater the advantages to both parties of fixing by the terms of the contract itself and easily ascertainable sum to be paid in that event.

A penalty clause is often requested by the original buyer (supplier) to ensure that the counter-purchase obligation will be fulfilled properly by the counter-purchaser. That is because the original buyer's agreement to import from the counter-purchaser has been made in expectation of hard currency generated through fulfilling the counter-purchase obligation. As a result, the original buyer is concerned to secure itself against non-performance or delayed performance by including a penalty clause. This need is intensified where the original buyer has no right either to void the primary sales contract or to reject the goods delivered pursuant to it because the primary contract has been drafted to be legally independent from the counter-purchase obligation. A specific sum may also be agreed on to be payable to the counter-purchaser if the goods are not available as agreed or they are inconsistent with the specifications agreed upon by the parties. In most cases, however, a penalty clause is not requested by the counter-purchaser if the other party's breach results in releasing the counter-purchaser from the obligation to counter-purchase because the counter-purchaser views the obligation as a burden demanded by the supplier.[56]

The amount of the penalty is generally fixed as a percentage of the value of the counter-purchase obligation which is not fulfilled.[57] This ratio varies from case to case but it is often between 5 percent to 20 percent of the value of the unfulfilled obligation and in rare cases it may reach to 50 percent. For example, in Indonesia a penalty of 50% is imposed on those exporting companies which fail to meet their counter-purchase obligation.[58] If the agreed

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56 In a sample countertrade contract with Romania, for example, the contract provides a penalty clause only for cases where the counter-purchaser does not fulfil, completely or in part, its commitment. This sample contract has been reproduced in: Verzariu, *Countertrade, Barter, and Offsets* (McGraw-Hill Book Company, New York, 1985) at 184-85.

57 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 54.

58 Those foreign companies exporting to Indonesia for the governmental procurement purposes have to undertake a counterpurchase contract which, among others, demands this agreement:

> If we fail to comply with our undertaking contained here [to counter-purchase] we hereby agree to pay to you as liquidated damages an amount equal to 50% of the difference

sum is close to the discount the counter-purchaser has to bear in disposing of the goods, the obliged party may prefer to pay the penalty rather than to fulfil its counter-purchase obligation.[59]

The protocol may require the counter-purchaser to furnish the other party with an unconditional and irrevocable bank guarantee issued in favour of the other party as a security against non-performance. In *State Trading Corporation v Golodetz*, for example, this amount was 3 percent of the value of sugar sold under the primary sales contract.[60] The amount of the guarantee, the bank in which the amount should be deposited, and the conditions upon which the amount is payable to the aggrieved party should be clearly agreed on in the protocol.

In drafting a penalty clause, there are some issues which should be borne in mind. First, it should be made clear whether the payment of the agreed sum releases the counter-purchaser from its commitment or is only for delay in performance and the counter-purchaser eventually has to fulfil its obligation anyway. When the contract does not specify the effect of paying the penalty, the payment of penalty prima facie releases the counter-purchaser from fulfilling its obligation.[61] Second, the parties may need to emphasise that payment of

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> between the total value of products actually [counter-] purchased pursuant to this undertaking and the foreign currency amount to be confirmed as aforesaid.

This model letter of undertaking has been reproduced in: Rubin, *The Business Manager's: Guide to Barter, Offset and Countertrade* (The Economist Intelligence Unit, London, 1986) at 86-87.

59 See Chapter 3, pages 112-113.

60 [1989] 2 Lloyd's L R 277 at 278.

61 One place that the payment of penalty may not release the party from performing the obligation is when the agreed sum is reasonably small as compared to damages resulting from non-performance. Article 6(2) of the *Uniform Rules on Contract Clauses for an Agreed Sum Due Upon Failure of Performance* drafted by the UNCITRAL provides:

> If the contract provides that the obligee is entitled to the agreed sum upon a failure of performance other than delay, he is entitled either to performance or to the agreed sum. If, however, the agreed sum cannot reasonably be regarded as compensation for that failure of performance, the obligee is entitled to both performance of the obligation and the agreed sum.

UNCITRAL, *Yearbook* vol XIV (UN, New York, 1983) at 272.

the agreed sum releases the counter-purchaser from its obligations without affecting the primary sales contract. Thus, the original buyer is not entitled either to void the primary sale or to reject the goods delivered under it.[62]

Third, the sum stipulated by the parties is not always upheld by courts of various legal systems. While the general principle of party autonomy argues that an agreed sum should be upheld, there is a concern that a sum which is unreasonably high compared to actual damages suffered by the aggrieved party is a punishment rather than a compensation.[63] Balancing contractual freedom with relieving innocent parties from excessive obligations has not always led to identical approaches in different legal systems. In Australia, as in other common law countries, these clauses are divided into valid and invalid.[64] Generally speaking, if the sum is a genuine pre-estimate of loss resulting from the breach of the contract, the term is valid as a liquidated damages clause. In comparison, the sum will be struck down as a penalty if the sum is imposed as a fine to ensure that the contract will not be broken.[65]

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62 In a Romanian counter-purchase contract, for example, the contract provides that in addition to payment of the penalty the original buyer has a right to reject the products delivered under the primary sales contract. Guyot, "Countertrade Contracts in International Business" (1986) *20 International Lawyer* 921 at 935.

63 In *Elsley v JG Collins Insurance Agencies* (1978) 83 DLR (3d) 1 at 15, Dickson J in delivering the judgment of the Supreme Court of Canada, said:

> It is now evident that the power to strike down a penalty clause is a blatant interference with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression.

See also *Esanda Finance v Plessnig* (1989) 166 CLR 131 at 140.

64 *Chitty on Contracts: General Principles* (Sweet & Maxwell, London, 27th ed 1994) at 1251; Allan & Hiscock, *Law of Contract in Australia* (CCH, Sydney, 2nd ed, 1992) at 83.

65 In Australia the following cases dealt with the issue of penalty clauses: *IAC (Leasing) v Humphrey* (1972) 126 CLR 131; *O'Dea v Allstates Leasing System* (1983) 152 CLR 359; and, *AMEV-UDC Finance v Austin* (1986) 162 CLR 170. See also *Esanda Finance v Plessnig* (1989) 166 CLR 131.

In determining whether a term is a penalty or a genuine pre-estimate of damage, a number of circumstances need to be borne in mind. As Mason and Wilson JJ observed in *AMEV-UDC Finance v Austin,* these circumstances include:

> (1) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to the defendant, and (2) the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in seeking to enforce the term.[66]

Recent cases show a greater latitude in upholding a sum agreed by the parties to a commercial transaction. An agreed sum may be struck down only if the aggrieved party can prove that the sum is extravagant or unconscionable in amount. In *AMEV Finance v Artes Studios Thoroughbreds*, Clarke JA concluded that

> contractual terms providing for the payment of agreed liquidated damages should be struck down as a penalty only if the agreed sum be either extravagant in amount or imposes an unconscionable or unreasonable burden upon a party. This approach would give full meaning to the distinction between a genuine attempt to agree as to the damage likely to flow from the event which triggers the operation of the clause and the imposition of a sanction or penalty against breach.[67]

Nominating the sum as *liquidated damages* in the contract is helpful to the extent that it creates prima facie evidence of that intention, but expressed categorisation is not conclusive.[68]

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66 (1986) 162 CLR 170 at 193. Earlier in *Dunlop Pneumatic Tyre v New Garage* [1915] AC 79 at 86-87, Lord Dunedin said:

> The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach.

67 (1989) 15 NSWLR 564 at 576.

68 In *O'Dea v Allstates Leasing System* (1983) 152 CLR 359 at 368, Gibbs CJ said:

> The question is 'not of words or of forms of speech, but of substance and of things', to use the words cited by Lord Radcliffe in *Campbell Discount Co. Ltd. v. Bridge* [1962] AC 600 at 624.

The attitude of the Australian legal system towards agreed sums has been criticised by both courts and commentators, especially when commercial transactions are involved.[69] In *Citicorp Australia v Hendry*, for example, Kirby J said:

> I also agree with the comment of Mahoney JA that the law relating to penalties is not satisfactory. If it were possible to approach this appeal free from authority, two changes at least would be contemplated, each of them relevant for a case such as the present.
>
> The first would involve recognition that a provision alleged to amount to a penalty, if otherwise enforceable in the contract between the parties, was enforceable until relief was granted to the party aggrieved upon the equitable ground that the provision ought not to be enforced because it did not amount to a pre-estimate, based on foreseeable losses, but a penalty and a sanction, the enforcement of which the civil law should not facilitate.
>
> The second change, relevant to the intervention of equity, would pay regard to the relative bargaining positions of the parties. Thus, the endeavour by a finance house, in a printed form, to impose conditions for breach upon a consumer borrowing a small sum, without the benefit of legal advice, would be treated differently to a commercial enterprise borrowing large sums for a business venture upon which it has the advantage of legal advice.[70]

In civil law countries, however, the approach taken as to penalty clauses is more sympathetic. In some countries the recognition of penalty clauses is so undeveloped that courts have no right to adjust the sum in any contract,[71] or in any commercial transaction.[72] In many countries, however, the courts are authorised to adjust the sum in some circumstances.[73] As a result, including excessive sums may not be upheld in many legal systems, and so the parties should include a reasonable sum to ensure its enforceability.

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69 Law Reform Commission of Victoria, *Liquidated Damages and Penalties* (Discussion Paper No 10, May 1988) at 5ff; Allan & Hiscock, *Law of Contract in Australia* (CCH, Sydney, 2nd ed, 1992) at 553.

70 (1985) 4 NSWLR 1 at 22-23.

71 Under Article 231 of the Iranian *Civil Code*, the courts must not intervene to adjust the sum agreed on by the parties.

72 For example, Article 348 of the German *Commercial Code* provides:

> A contractual penalty to which a businessman has obligated himself in the operation of his business enterprise cannot be reduced by reason of the provisions of Article 343 of the Civil Code.

Compared with Article 343 of the German *Civil Code* which enables the courts to reduce the sum if it is disproportionately high. Hermann, *International Trade Terms* (Graham & Trontman, London, 1994) at 124.

73 As above.

Due to difficulties arising from the various approaches taken by different laws to penalty clauses, the UNCITRAL has developed the *Uniform Rules on Contract Clauses for an Agreed Sum Due Upon Failure of Performance.*[74] These rules can be incorporated into the protocol as they are or with amendments.[75] Alternatively, the parties may choose the UNIDROIT Principles as the governing law. Article 7.4.13 of the Principles reads:

> (1) Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm.
> (2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.[76]

1.8. Transferability and Assignment

When the original exporter required to counter-purchase cannot use the goods for in-house consumption or market them through its own operation, it may need to transfer the counter-purchase commitment to a third party.[77] In particular, such a need increases when the original exporter is infrequently involved in counterpurchase practices and has no facilities to dispose of the goods itself.[78] The third party may be a trading house, broker, or countertrade specialist having countertrade experience and facilities which market the goods against a premium or at a discount. It is, therefore, wise to include appropriate terms in the protocol as to the transferability and assignment of the commitment.

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74 UNCITRAL, *Yearbook* vol XIV (UN, New York, 1983) at 272.

75 Article 9 of the *Uniform Rules on Contract Clauses for an Agreed Sum Due Upon Failure of Performance*.

76 UNIDROIT, *Principles of International Commercial Contract* (UNIDROIT, Rome, 1994) at 213.

77 In this connection, Hill of General Motors said:

> We couldn't use all or even most of the goods we obtain in counterpurchase within General Motors. While we only work to support General Motors' sales, we have to place most of the goods outside the company, and we usually employ a specialist to move products we don't understand.

Dizard, "The Explosion of International Barter" (February 7, 1983) *Fortune* 88 at 91.

78 Welt, "Unconventional Forms of Financing: Buy-Back/ Compensation/ Barter" (1990) 22 *New York Uni International Law & Politics* 461 at 470.

It should be noted that, if the parties fail to address the issue of transferability in the contract, the subsequent assignment of the counter-purchase obligation generally needs the agreement of the supplier. In *Tolhurst v Associated Portland Cement Manufactures*, Sir R Collins said: "Neither at law nor in equity could the burden of a contract be shifted off the shoulders of a contactor on to those of another without the consent of the contractee."[79] The original exporter may not be released from its counter-purchase commitment without the consent of the original importer (supplier). On the other hand, the supplier may want to include in the contract an explicit term stating that the whole or any part of the commitment should not be assigned without its written consent.[80] In cases where a subsequent consent is necessary to obtain before assigning the obligations, the contract should specify that such permission will not be unreasonably withheld.

However, in other circumstances, a third party may fulfil the counter-purchase obligation on behalf of the original exporter even without the consent of the original importer. Such cases should be distinguished from assignment of the contractual obligation which requires the consent of the obligee.[81] In these cases, the third party fulfils the obligation as an agent for the exporter and consequently the original exporter remains liable for breach of the contract and for any default in the third party's performance. However, if the performance obviously

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79 [1902] 2 KB 660 at 668.

80 In a counter-purchase contract drafted by Malaysia the issue of assignment was regulated as follows:

> The [name of the counter-purchaser] shall not assign or transfer to a third party all or part of the benefits or obligations of this agreement without the written consent of the [name of the supplier] and such consent if given shall not relieve the [name of the counter-purchaser] from any liabilities or obligations under this agreement.

Hober, "Countertrade: Negotiating the Terms" (March 1987) *International Financial L Rev* 28 at 32.

81 The performance of the contract by a person other than the obligor is known as vicarious performance. It is "quite a mistake to regard that as an assignment of the contract: it is not". *Davies v Collins* [1945] 1 All E R 247 at 249.

depends on the personality of the party, the obligee may reject the fulfilment carried out by a person other than the original obligator. To avoid any disagreement in this respect, the parties may expressly state that the counter-purchaser can perform the obligation through either its affiliated companies or other firms nominated by the counter-purchaser.

The mere assignment of the commitment to a third party generally gives the transferee no better position concerning the contractual rights when compared to the position of the transferor.[82] As a result, if the counter-purchase obligation is transferred to a third party, all limitations imposed by the supplier as to the kind of goods, the time frame, the price, marketing restrictions and so on need to be complied with by the third party as well unless otherwise agreed.

When the obligation is assigned to a third party by the consent of the original importer, the original exporter is prima facie discharged from the obligation, unless otherwise agreed. As a result, it is important for the original importer to ensure that the third party is able to meet the counter-purchase obligation. An alternative option is to agree that the original exporter should remain jointly liable with the third party for any breach or secondarily liable to be referred to in the case of the third party's default. If assignment is to discharge the original exporter, it should be made clear that by the time when the contract of assignment becomes effective, the original exporter will be discharged from the obligation.

If the transferability of the counter-purchase obligation is to be included in the protocol, the transferability may be conditional upon satisfaction of certain criteria. The contract may require, for example, that the transferor must include in the subsequent assignment contract

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82 The maxim *nemo dat quod non habet* says "that no one can transfer a better title to goods than he himself possesses". *Benjamin's Sale of Goods* (Sweet & Maxwell, London, 3rd ed 1987) at 277.

any requirement imposed by the original importer as to the kind of goods, the prices, resale process and so on. The contract may also explicitly deal with the following issues if the subsequent consent of the supplier is not needed: i) whether or not the original exporter will remain liable after assigning the obligation to a third party; and ii) whether notice should be given to the original importer when an assignment contract is entered into.

1.9. Marketing and Resale Restrictions

The protocol may provide that the counter-purchaser has to use the goods for in-house consumption only and consequently has no right to resell them in a market. In most cases, however, the goods are not for in-house consumption and the counter-purchaser needs to resell them directly or through an agent. It is, therefore, advantageous for the counter-purchaser to be able to sell and market the goods free from any restrictions, supervision or interference of the supplier.[83] Any marketing restriction may adversely affect the counter-purchaser's ability to sell the products directly in a market or to find a person to handle the goods at a reasonable discount or premium. On the other hand, the supplier may insist on imposing certain limitations as to the potential buyers, resale prices, the territories in which the goods can be traded, or the shape, packages, and appearance of the goods in order to protect its own interest.

The reasons underlying the imposition of restrictions on the resale process include: i) The supplier has already granted an exclusive distributorship right to a third person (eg an agent or a distributor) in a given territory which forbids the supplier to sell its products there directly or indirectly. ii) Sometimes, the supplier demands a counter-purchase commitment

83 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981) at 50.

in order to penetrate new markets for its products without damaging its established traditional markets. iii) In some cases, the supplier does not want to market its products through any distributors whatsoever, but rather it wants to benefit from the name and sometimes the brand of a well-known company to develop a reputation for its products or to maintain its own reputation in a particular market.

When the contract has no stipulation as to the resale restrictions, the counter-purchaser may resell the goods free from the interference and supervision of the supplier. If certain limitations are to be imposed on resale, they should be clearly addressed in the counter-purchase contract. A stipulation like *resale of goods must not be damaging to the supplier's traditional market* is too ambiguous because selling in a market may in one way or another affect the price of those goods in other marketplaces. Apart from clarity of restrictions, the parties should also be aware that imposing resale restrictions may be contrary to mandatory rules of either the supplier's or the counter-purchaser's country which not only makes the contract or those restrictions invalid but also may result in the imposition of the pecuniary penalty.[84] In Australia, under the doctrine of restraint of trade certain contractual arrangements are void in accordance with common law[85] or statues.[86] The purpose of these mandatory rules is to maintain sound competition in the marketplace.[87]

84 Section 76 of the *Trade Practices Act* 1974 (Cth).

85 *Howard F Hudson v Ronayne* (1972) 126 CLR 449.

86 Part IV of the *Trade Practices Act* (1974).

87 In *Refrigerated Express Lines v Australian Meat and Livestock* (1980) 44 FLR 455 at 460-461, Deane J explained the purpose of the Part IV of the *Trade Practices Act*:

> The general purpose and scope of the Part [IV] can be described by saying that it contains provisions which proscribe and regulate agreements and conduct and which are aimed at procuring and maintaining competition in trade and commerce. Broadly speaking, those provisions either control or proscribe the making of certain contracts or arrangements or the reaching of certain understandings, the giving or extracting of certain covenants in

2. Advance-Purchase

In a countertrade transaction, the obligation to purchase some products from the importing party may be undertaken by the exporting party prior to its own export. The exporting party purchases in advance to satisfy a requirement which must be fulfilled to have access to a market. The peculiarity of this practice that distinguishes it from a normal purchase contract lies in its introductory status to the main export contract which is expected to be entered into later. Like counterpurchase, an advance-purchase transaction should also deal with two sets of issues: purchasing certain products from the importing party which is similar to conventional sales, and the connection between this purchase and the subsequent export. The issue of linkage which is the focus of this section may be set out in a protocol or included in the advance-purchase contract itself. Drafting appropriate terms to secure the subsequent export requires an analysis of the situation underlying the necessity to conclude an advance-purchase contract. Since a trading party may have no hard currency to buy from the exporting party, the exporting party purchases in advance some products from it to generate hard currency for its own exports. Alternatively, an advance-purchase obligation may be undertaken to meet a countertrade requirement imposed by a foreign government demanding a counter-export as a condition of any export to the country. These two situations are dealt with here separately:

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relation to land, the engaging in conduct involving a secondary boycott, engaging in the practices of monopolisation, exclusive dealing or resale price maintenance, engaging in predatory price discrimination, and the increasing of market share by means of take-over or merger. ... [T]he relevant legislative controls and proscriptions contained in Part IV are largely directed to conduct or agreements, arrangements or understandings in trade or commerce or involving a foreign, trading or financial corporation.

2.1. Creating Hard Currency for Exports

In cases where an exporter engages in an advance-purchase contract to create hard currency for its own export, the advance-purchase contract is a normal sale contract under which certain products are transferred to the other party against money. The distinguishing feature of advance-purchase rests on the fact that the proceeds have to be blocked and allocated to secure the payment of the purchaser's own exports. Thus, extra provisions should be drafted to ensure that the proceeds will be allocated appropriately for later exports. Since the advance-purchaser enters into the agreement to generate hard currency in order to secure its own exports, it is a risk to permit the proceeds to be held under the control of one of the parties. Even in cases where the parties enjoy an established relationship, the risk of insolvency, third-party claims or unwillingness to pay still remains. As a result, establishing a mechanism to ensure that the proceeds will be allocated for the subsequent export is a key issue that must be dealt with adequately. Such assurance may be achieved under two mechanisms: establishing an escrow account or issuance of crossed letters of credit.

2.1.1. Establishment of an Escrow or Blocked Account

An effective way to secure the availability of hard currency for later exports is to open an escrow account in which all proceeds of the advance-purchase are to be placed.[88] One of the most famous examples of advance-purchases involved Pepsi and Stolichnaya vodka. Pepsi purchased vodka from Russia in advance, putting the money in an escrow account.

88 Verzariu, "Trends and Developments in International Countertrade" (November 2, 1992) 113 *Business America* at 2.

When Russia wanted to purchase something like syrup from Pepsi, the fund could be used for that purpose.[89] During its exchange crisis in 1985, the Philippines also used this method to sell bananas to Korea and purchase low-density polyethylene in return.[90] In a very recent case, Serbia, which is facing extreme difficulties in trade financing, agreed to trade with China on a countertrade basis. Under the arrangement, Serbia exported certain products to China and the overall revenues will be put in an escrow account to meet purchases of Chinese goods.[91]

Generally speaking, an escrow account is a special bank account where the money is deposited to be used for some special purpose, without becoming a part of the general assets of the customer. In advance-purchase transactions the proceeds are to be paid to the escrow account to be used as the payment of the advance-purchaser's exports to the other party. Opening such an account and linking it to the advance-purchase contract requires two sets of arrangements. First, a set of contractual provisions needs to be worked out by the parties to establish a framework for opening and managing the account. Second, in accordance with these provisions, an escrow account needs to be opened by a bank and by at least one of the contracting parties.

2.1.1.1. Contractual Provisions Establishing the Framework of the Escrow

In the advance-purchase contract, a set of provisions has to be drafted by the parties, according to which the escrow account is to be opened, maintained and managed. Since one party to the escrow account is a bank which does not usually participate in drafting the

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89 *Financial Times* (November 20, 1990) at 3.

90 Santamaria, "Countertrade" in Horn (ed), *The Law of International Trade Finance*, (Kluwer, Deventer, the Netherlands, 1989) at 55.

91 6(5) *Central European* (May 1996) at 17; available in Lexis-Nexis, Business News Library.

advance-purchase arrangement, the parties should consider all relevant mandates or usages restricting the action of the parties in opening or managing the escrow account in a given country. In other words, the parties should draft their contract in the light of the provisions surrounding an escrow account in a particular place. As a result, the location of the escrow account is the first issue that needs to be agreed on in the contract.

The Place of the Account

When exporters agree to purchase some products in advance, they prefer to keep money in an escrow account held in a country of a developed monetary and banking system with few restrictions on depositing to or withdrawals from the account. For example, Western exporters usually agree to keep the account in branches of common banks in Western Europe or the US.[92] Nevertheless, in selecting the place of the escrow the following considerations should be borne in mind:

i) The possibility of transferring proceeds to that location is the first issue that should be taken into consideration. In some countries, the currency generated by any exports may not to be transferred to a third country. For example, when Iranian companies export goods, they may be required to return the funds to the country or to use them (or a percentage of them) for importing some products. In this situation, the location is limited to one of the contracting parties' countries.

ii) In some countries, depositing foreign currencies may have some restrictions or it may be impossible altogether.[93] In Australia, however, since the relaxation of exchange control

92 Whitley, "Flourishing as Never Before" (February 7, 1985) *Financial Times* at VI.

93 For example, until January 1, 1990 individuals and corporations were not permitted to open foreign currency accounts in the US. *American Banker* (January 9, 1989) at 2.

requirements, a Foreign Currency Account may be denominated in any major currency, enabling international trading companies to manage their foreign currency transactions more effectively.[94] Under the arrangement, interest may or may not be payable to such an account.[95] However, some Australian banks pay interest only on account balances exceeding the minimum amount required to open such an account.[96] Operation by cheque may not be permitted.[97] The funds are available on demand and overdraft facilities may be arranged. Making deposits or withdrawals may be restricted to the branch where the account is kept.[98] Some banks provide a Foreign Currency Account only to business customers for business related purposes[99] and some other banks restrict holding such an account to Australian residents.[100]

iii) In some countries escrow accounts may be subject to special regulations. In Australia some sorts of trust accounts such as *solicitor's trust accounts* are subject to statutory regulations.[101] The *Trust Accounts Act* 1973 (Qld) applies to the trust accounts which

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94 National Australia Bank, *Finance of International Trade* (National Australia Bank, Australia, 1984) at 75.

95 The rate of interest to a Foreign Currency Account is dependent on the size of the balance held and it is calculated daily based on a market rate applicable for the currency concerned.

96 At the time of writing, the minimum account balance is equivalent to AU$5,000 in the Commonwealth Bank and the Westpac Banking Corporation, and to AU$10,000 in the ANZ bank.

97 Weaver & Craigie, *Banker Customer* (LBC, Release 12, 1996) at 3091. In accordance with the information released by Westpac, cheque books and handycard access are not available on Foreign Currency Accounts. Westpac, *Foreign Currency Accounts: Terms and Conditions* (A brochure published by Westpac for its customers, effective 1 July 1995).

98 In accordance with the Westpac terms and conditions, deposits to a Foreign Currency Account may be made at any Westpac branch in Australia, but withdrawals of funds from a Foreign Currency Account may be made only at the branch where the account is held. Westpac, *Foreign Currency Accounts: Terms and Conditions*.

99 For example, the Westpac Banking Corporation.

100 For example, the Commonwealth Bank.

101 *Legal Practitioners Act* 1970 (ACT)
Legal Practitioners Act 1974 (NT)
Legal Profession Act 1987(NSW)
Trust Account Act 1973 (QLD)
Legal Practitioners Act 1981 (SA)
Legal Profession Practice Act 1959 (TAS)
Legal Profession Practice Act 1958 (VIC)
Legal Practitioners Act 1959 (WA).

solicitors, conveyancers and public accountants are required to keep with banks in the course of their professions or businesses.[102] Other cases of trust accounts are, however, outside these statutory rules. In the Australian context, an escrow account may be managed through two methods: opening a *trust account* or opening a *special purpose account*.

Trust Accounts

A trust account may be defined as a fund placed with the bank of a fiduciary character to be used for a specific purpose, without becoming a part of the customer's general assets.[103] The advantage of a trust account is that the legal regime of trust accounts is more established, than special purpose accounts. When a trust account is brought to the knowledge of the bank, the responsibility of the banker is to do all it can to see that operations on the account are in accordance with the terms of the trust instrument. This rule is adequately stated in *Jackson v Bristol and West of England Bank*:

> It was equally clear, on the other hand, that if the banker had knowledge of the misapplication of money, such as trust money, received and paid in by his customer, he, the banker, was just as much liable for the amount as if he had himself been nominated trustee of the money and the money had come into his hand, as trustee.[104]

In *Fuglsang v the English Scottish and Australian Bank Limited*, the following passage was quoted with approval from *Hart's Law of Banking*:

> The primary proposition is that a banker who receives into his possession moneys of which his customer has, to his knowledge, become the owner in a fiduciary capacity contracts the duty not to part with them, even at the mandate of his customer, for purposes which he knows are inconsistent with the customer's fiduciary character and duty, and if he has knowledge of the misapplication of trust moneys by the customer he is just as much liable as if he had been nominated a trustee and the money had come into his hand as such.[105]

102 Section 4(1) of the *Trust Account Act* 1973 (Qld).
103 9 *Corpus Juris Secundum* at 575.
104 [1885] 1 TLR 522 at 522.
105 [1959] Tas SR 155 at 158.

As a result, if the bank was aware or should have been aware that the money was being paid away in breach of trust, then the bank has responsibility towards the beneficial owners of the fund. The transfer of money from the trust account to the private account of the trustee may be perceived as a case where the bank is a party to the breach of trust,[106] especially if the bank itself has derived some benefit from the payment.[107]

The other responsibility of the bank is to not combine a trust account with the trustee's private accounts.[108] The bank must exercise due care and skill that all operations on the trust account are consistent with the trust agreement. The bank also has no right to set off the balance of a trust account against the customer's indebtedness in other accounts.[109]

A trust account in Australia is subject to general principles of trust law as well as the *Trustee Acts* that are in force in each jurisdiction.[110] Accordingly, the trust agreement cannot be cancelled without prior approval of the advance-seller (beneficiary). The trustee who conducts the trust account holds the title of the account but is bound to exercise its right for the beneficiary's interests.[111] When the funds are provided for a particular purpose and that purpose fails, a resulting trust in favour of the trustee arises.[112] As a result, the

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106 *Lawson v the Commercial Bank of South Australia* (1882) 22 SALR 74; *Westpac Banking Corp v Savin* [1985] 2 NZLR 41.

107 In *Gray v Johnston* [1868] LR 3 HL 1 at 11, Lord Cairns stated: "If it be shown that any personal benefit to the bankers themselves is designed or stipulated for, that circumstance above all others will most readily establish the fact that the bankers are in privity with the breach of trust".

108 *Bank of New South Wales v Goulburn Valley Butter* [1902] AC 543.

109 *Barclays Bank v Quistclose Investments* [1968] 3 All ER 651.

110 *Trustee Act* 1925 (NSW)
Trustee Act 1958 (Vic)
Trusts Act 1973 (Qld)
Trustee Act 1936 (SA)
Trustees Act 1962 (WA)
Trustee Act 1898 (Tas)
Trustee Act 1893 (NT).

111 Weaver & Craigie, *Banker Customer* (LBC, Release 12, 1996) at 3143.

112 *Barclays Bank v Quistclose Investments* [1968] 3 All ER 651; *Re Evtr* [1987] BCLC 646 at 650.

funds deposited in the account are protected against third-party creditors of either the trustee or the beneficiary.[113] The funds may generate interest in favour of the trustee.

Special Purpose Accounts

When under an agreement the money is left with the bank to be used for some special purpose, the account is a special purpose account.[114] The agreement may provide that the money is to be paid to someone upon certain conditions, or to be returned to the purchaser if the title is found defective and to the vendor if the title is approved, or to be paid for a particular debt. Where a deposit is made for a specific purpose, a question arises as to whether or not it is a trust account. It can be said that a trust account operates on a fiduciary basis, while a special purpose account is based on the agreement between the bank and the customer. The prevailing view in the US is that the bank has "the fiduciary duty of an agent or trustee to apply the deposit to the particular purpose for which it was delivered to the bank and in case of the misapplication of the deposit, it may be followed on the trust fund theory".[115] As a result, in the US the legal effect of a special purpose account may be the same as a trust account.

In the Anglo-Australian context, *Barclays Bank v Quistclose Investments* is significant.[116] Rolls Razor, a company in serious financial difficulties and with a large overdraft exceeding its limit, obtained a loan from Quistclose Investments on agreed conditions to be used to pay a dividend. The fund was deposited into a special account with Barclays who knew the

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113 *Pannell v Hurley* (1845) 63 ER 716 at 718.

114 10 *American Jurisprudence* 2d at 326.

115 10 *American Jurisprudence* 2d at 342; in *Union Properties v Baldwin* 47 NE 2d 983 (1943) at 987, it has been said that "a deposit for a specific purpose creates a trust."

116 [1970] AC 567.

conditions. Rolls went into liquidation before the dividend was paid. On the following day, Barclays set off the credit balance of Rolls against other accounts. Later Quistclose demanded repayment of the fund from Barclays. It was held that when money was deposited to be applied to a particular purpose, the money was held to be in trust for that purpose. In this case, two issues have been well stressed. First, when a deposit is for a specific purpose, it gives rise to a relationship of a fiduciary character or trust.[117] Second, if the primary trust fails, a resulting trust in favour of the provider of the money arises.[118]

It seems that the reason underlying the courts' inclination to apply the trust theory to accounts for special purposes is to support the beneficiary or the trustee in cases where their agreement with the bank provides no mandate in this connection. Through applying trust theory to special purpose accounts, the funds deposited for the purpose stated are dealt with as trust funds and consequently, are subject to general law of trust. If the parties mandate in their agreement with the bank all necessary steps that should be followed, the courts may not intervene. As a result, if funds are deposited into a specific account to be used for some particular purpose, without specifying detailed duties of the bank in operating on the funds, the account may be dealt with by an Australian court as a trust account.

However, the parties may enter into an agreement with the bank to deposit for a particular purpose, specifying in detail the duties of the bank in administering this account. They may specify, for example, that the funds must not be set off by the bank against other accounts of the customer, that the funds are to be paid to the beneficiary if certain conditions are met, and that the funds are to be repaid to the provider if the primary purpose fails. In such a

117 [1970] AC 567 at 580.
118 As above; these two conclusions were followed in *Re Evtr* [1987] BCLC 646.

situation, the relationship between the bank and the customer is regulated by the agreement, rather than being mandated by the trust theory and statutory trust regulations,[119] especially if the parties state that their relation does not constitute a trust. A question thus arises as to whether the funds are protected against third-party creditors. It is most probable that courts in Australia by analogy apply the trust account principles to accounts for specific purposes providing a degree of protection to the funds against seizure by third-party creditors. For an assured result, the funds may be pledged in favour of the beneficiary as security against arrest.[120]

2.1.1.2. The Contents of the Advance-Purchase Agreement

If the parties wish to open an escrow account in Australia for an advance-purchase purpose, whether in the format of a trust account or a special purpose account, they must draft an agreement under which the account is to be administered. The provisions of the agreement need to be exhaustive if a special purpose account is chosen. For a trust account, many issues may be left to the general rules of trust law. In addition to the name of the bank and its location, there are a number of other issues that need to be addressed in the agreement. The agreement should state that the advance-seller is the owner or the trustee and the advance-purchaser is the beneficiary of the account. They may need to state that although the advance-seller has title to the account, its operation of the account must not be inconsistent with the rights of the beneficiary (advance-purchaser).

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119 [1970] AC 567 at 581

120 Commonwealth Secretariat, *Countertrade: Guidelines for Developing Countries* (Commonwealth Secretariat, London, 1988) at 54.

The parties should agree that the payment of the proceeds into the account is to be viewed as the absolute receipt of the price of the advance-purchase contract. They may provide that payment to the account should be made through issuance of a letter of credit from the advance-purchaser's bank in favour of the advance-seller to be deposited into the account. The terms upon which the funds are to be paid to the beneficiary should be drafted very carefully. A simple way is to agree that the funds are payable to the beneficiary by the instruction of the advance-seller, for example, through issuing a cheque, or through standard documentary letters of credit, issued preferably by the same bank.[121] Alternatively, they may agree that the bank has to pay the funds to the beneficiary against presenting certain documents, such as a bill of lading, certificate of quality and so on, without any further instruction of the advance-seller.

Another issue that needs to be included in the agreement is whether a part-drawing is allowed or not. The parties may agree that the interest to be earned on the account should be capitalised, be used to compensate the bank charges, be divided between the parties, or be transferred to the trustee.

The terms upon which the advance-seller can operate on the account need to be incorporated into the agreement. The parties may agree that after a specific date, the advance-seller may operate the account independently in relation to funds not used. The type and the quality and quantity of the goods to be purchased by the funds should be specified in the agreement. Both the parties should undertake a commitment to sell and to purchase the given products over a period of time. If the advance-seller fails to purchase, a

121 Santamaria, "Countertrade" in Horn (ed), *The Law of International Trade Finance*, (Kluwer, Deventer, the Netherlands, 1989) at 55.

percentage of the funds, as a penalty[122] or otherwise, must be paid to the other party. If the advance-purchaser fails to fulfil its obligation over a specific time, the other party can transfer the funds from the account. Alternatively, they may agree that in case of any dispute, the right of each party in relation to the funds will be determined through arbitration or other dispute settlement, worked out in the agreement.[123] They may agree that the money is transferable to the advance-seller upon an express request by both the parties, irrespective of the contractual terms. They may specify the situations in which the account would be closed.[124]

Unless otherwise stated in the contract, the funds held in the escrow account must be used for advance-purchaser's exports. If the advance seller needs to release the funds, the parties have to reach an agreement. For example, in a countertrade transaction Brazil's State-owned oil company had purchased oil in advance from Nigeria. The proceeds were kept in an escrow account with the New York branch of the United Bank for Africa to be used to import products from Brazil. About $150 million were still held in the account when Nigeria negotiated with Brazil to release the funds blocked for Brazil's exports to Nigeria. An agreement was reached between two parties to release the funds against a 10 percent release fee.[125]

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122 See above, pages 322ff.

123 Brown & Franklin, *Countertrade Paying in Goods and Services* (Longman, London, 1994) at 14.

124 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 98.

125 Holman, "Countertrading 2: Strategy Beset by Problems" (March 23, 1987) *Financial Times* at 26.

2.1.1.3. The Agreement With the Bank

Upon the provision of the advance-purchase arrangement, an agreement needs to be entered into by the given bank and at least one of the contracting parties. Whether a trust account or a special purpose account is to be selected, the issue must be brought to the knowledge of the bank. The best way is that the account be styled clearly as a trust account, or a special purpose account. It should be stated that the owner of the account (in special purpose accounts) or the trustee (in trust accounts) is the advance-seller, and the beneficiary is the advance-purchaser. The bank may be required to administer the account in accordance with the provisions set forth in the advance-purchase agreement. Hence, a copy of the advance-purchase agreement should be provided to the bank. Alternatively, the bank may restrict its responsibility to examining the conformity of the documents with the requirements set forth in its agreement with the parties, rather than with provisions of the underlying advance-purchase agreement. The interest rate, the bank charge and the duration of the account may need to be specified in the agreement. If the account is a Foreign Currency Account, the type of currency, and the means of withdrawing or transferring the funds may need to be agreed on.

2.1.2. Using Crossed Letters of Credit

2.1.2.1. Overview

The second mechanism to ensure that the proceeds of the advance-purchase contract will be allocated for the advance-purchaser's own exports is to issue crossed letters of credit. The letter of credit (also called the *documentary letter of credit*, *documentary credit*, or the *commercial letter of credit*) is a commercial instrument frequently used as a means of financing international transactions. Letters of credit are supposed to solve the problem of delivery and payment inherent in international trade.[126] By dispatching the goods, the seller wants to be sure that the price will be paid on time. On the other hand, the buyer does not want to pay the price before taking possession of the goods and ensuring that they are in conformity with the contract. A letter of credit is a solution to the conflicting interests of buyers and sellers. The mechanism of letters of credit is stated in the words of Denning LJ in *Pavia & Co SPA v Thurmann-Nielsen*:

> The sale of goods across the world is now usually arranged by means of confirmed credits. The buyer requests his banker to open a credit in favour of the seller and in pursuance of that request the banker, or his foreign agent, issues a confirmed credit in favour of the seller. This credit is a promise by the banker to pay money to the seller in return for the shipping documents. Then the seller, when he presents the documents, gets paid the contract price. The conditions of the credit must be strictly fulfilled, otherwise the seller would not be entitled to draw on it.[127]

Due to the wide use of letters of credit, and the need to make uniform the banking practices in handling them, the *Uniform Customs and Practice for Documentary Credits* (UCP) have been elaborated by the International Chamber of Commerce (ICC). Although its first version was adopted only by a limited number of bankers, mostly West European,[128] later revisions have been adopted by a larger group of bankers in different parts of the world.[129] Today, all countries around the world follow the UCP in some way.[130] The latest version of the UCP, known as the 1993 Revision, came into effect on January 1, 1994.[131] The UCP

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126 The purpose of using letters of credit has been explained in *Guaranty Trust v Hannay* [1918] 2 KB 623 at 652; and in *Ramalingam v State of Madras* (1962) 49(2) AIR 1148 at 1151-1152.

127 [1952] 2 QB 84 at 88.

128 *Benjamin's Sale of Goods* (Sweet & Maxwell, London, 3rd ed 1987) at 1149.

129 At 1149.

130 Horn, "Payment and Financing Arrangements in International Trade" in Horn (ed), *The Law of International Trade Finance*, (Kluwer, Deventer, the Netherlands, 1988) at 16.

131 For a critical evaluation of changes implemented by the 1993 revision, see Buckley, "The 1993 Revision of the Uniform Customs and Practice for Documentary Credits" (June 1995) 6 *J Banking & Finance L & Practice* 77.

provisions cover a variety of issues relating to letters of credit, such as different forms of documentary credits, the requirements for the issuing, advising and confirming of the credit, the liabilities and responsibilities of the banks, the necessary documents for the letter of credit, the transfer of a credit, and the assignment of proceeds. The various versions of the UCP have been adopted by Australian bankers since 1963.[132] The 1993 version of the UCP came into effect throughout Australia on January 1, 1994.

Article 1 of the UCP provides that the UCP rules apply to a letter of credit if the parties have embodied them in their contract and to the extent otherwise expressly not agreed. As a result, the application of the UCP to any letters of credit issued in Australia needs to be incorporated by reference to the UCP in letters of credit. In some countries, however, the UCP is considered a commercial custom to be applied even in cases where no reference has been made in the letter of credit.[133] Certain rules of the UCP, such as the autonomy of the letter of credit from underlying contracts[134] and strict compliance of documents with the terms and conditions of the credit[135] are generally agreed as international trade usages.[136] In practice, the UCP as a set of standard terms has gained world wide acceptance. It is hardly possible to find significant banks making no reference to the UCP when they are involved in any stage of letters of credit.

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132 National Australia Bank, *Finance of International Trade* (National Australia Bank, Australia, 1984) at 52.

133 At 52.

134 Uniform Customs and Practice for Documentary Credits 1993, Article 3 & 4; *Contronic Distributors v Bank of New South Wales* [1984] 3 NSWLR 110; *Westpac Banking Corp v South Carolina National Bank* (1986) 64 ALR 30.

135 Uniform Customs and Practice for Documentary Credits 1993, Article 14; *Equitable Trust Company of New York v Dawson Partners* (1927) 27 Lloyd's L R 49; *Soproma SPA v Marine & Animal By-Products Corporation* [1966] 1 Lloyd's Rep 367.

136 Schmitthoff, *Schmitthoff's Export Trade* (Stevens, London 9th ed 1990) at 404-407; Schmitthoff, "International and Procedural Aspects of Letters of Credit" in Horn (ed), *The Law of International Trade Finance*, (Kluwer, Deventer, the Netherlands, 1988) at 227.

The Uniform Customs and Practice for Documentary Credits (1993 Revision) defines a letter of credit as follows:

> For the purpose of these articles, the expressions 'documentary credits(s)' and 'standby letter(s) of credit' ... means any arrangement, however named or described, whereby a bank (the issuing bank), acting at the request and on the instructions of a customer (the applicant for the credit), is to make a payment to or to the order of a third party (the beneficiary), or is to pay or accept bills of exchange (drafts) drawn by the beneficiary, or authorises another bank to effect such payment, or to pay, accept or negotiate such bills or exchange (drafts), against stipulated documents, provided that the terms and conditions of the credit are complied with.[137]

Since crossed letters of credit are a kind of letter of credit, they are generally subject to the UCP rules. The UCP rules are sufficiently flexible to allow the parties to add appropriate terms, as requested, to adjust the rules to a situation like a crossed letter of credit. Thus, the parties are to include in the letter of credit necessary terms in the light of the UCP rules to make the credit correspond to their special needs. Under a crossed letter of credit, the advance-purchaser advises its bank to issue a credit in favour of the advance-seller upon satisfaction of certain conditions. One of these conditions is an irrevocable instruction from the advance-seller that the proceeds are to be allocated as a basis for the payment of the advance-purchaser's export.[138] Crossed letters of credit involve issuance of two credits in opposing directions. The first one is opened by the advance-purchaser in favour of the other party as the payment of the advance-purchase contract. Based on the credit generated by the first letter of credit, the second one is opened by the advance-seller in favour of the advance-purchaser to cover the payment of the latter's export.[139]

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137 Article 3 of the *Uniform Customs and Practice for Documentary Credits* 1993.

138 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 99.

139 Brown & Franklin, *Countertrade Paying in Goods and Services* (Longman, London, 1994) at 15.

2.1.2.2. A Hypothetical Example

The following hypothetical example demonstrates the mechanism of issuance of a crossed letter of credit. Suppose an Iranian company lacking sufficient hard currency reserves wants to purchase beef from an Australian company. To generate sufficient hard currency for its Iranian trading partner, the Australian company agrees to purchase in advance certain products from the Iranian company upon the condition that the proceeds will be allocated for the export of beef from the Australian partner to Iran. There are two sets of problems that need to be managed by the parties. The first set of problems is not exclusive to this case, but may be found in any international sale contract. The distance between the parties and the substantial period of time for shipment raise the problem of furnishing security. The seller company does not want to part with the possession of its goods before being fully paid off, while the buyer company, unwilling to pay in advance, needs to be protected against default in the seller's performance. Payment via a letter of credit enables the parties to use the facilities of the banking system as a safeguard to overcome these problems. In addition to the advantages underlying the use of letters of credit in solving these problems, the use of letters of credit may be mandatory in the buyer's country as a part of exchange control or import control regimes.

The second set of problems rests on the expectation of the Australian company in ensuring that the proceeds of its purchase will be allocated to its own beef export. One appropriate response to this need is to use a crossed letter of credit. Hence, the Australian company (the advance-purchaser) and the Iranian company (the advance-seller) are to agree on terms of the advance-purchase contract, such as price, specification of the goods, method of transportation, and the persons responsible for paying freight, insurance and so on. They must also agree that the proceeds of the letter of credit opened by the Australian party are to be blocked as the basis for the issuance of a letter of credit in its favour. In accordance with the contract terms, the Australian company has to apply to a bank, called the issuing bank (generally an Australian bank), for a letter of credit in favour of the Iranian company. An application form needs to be completed. This is a standard form drawn up in the light of the UCP rules, including some blank spaces to be completed in accordance with the parties' needs. The instruction as to the documents which need to be presented by the seller is one of the most important issues to be addressed in the application form. In addition to a bill of lading, the invoice and an insurance policy, an irrevocable instruction to allocate the proceeds to be used for a counter-letter of credit also needs to be added in response to the need of blocking the proceeds to be used for the export of Australian beef to Iran.

The issuing bank sends the letter of credit to a bank, called the advising or correspondent bank (generally an Iranian bank), advising it to open a credit in favour of the Iranian company in conformity with the specifications set out in the letter. Accordingly, the advising bank informs the beneficiary of the letter of credit and the documents needed to be presented to the bank. At this stage the Iranian company should check that its terms and conditions match the advance-purchase agreement and can be complied with. The Iranian company ships the goods, then assembles the required documents to be presented to the advising bank. The advising bank checks the documents and, if they are in order, informs the Iranian company that upon this credit it is able to open a letter of credit in favour of the Australian partner.

The Iranian company purchases beef from Australia and requests its Iranian bank to open a letter of credit in favour of the Australian exporter. Upon the credit generated by the previous letter of credit, the Iranian bank (now as an issuing bank) opens a credit and sends it to the Australian bank (now as an advising bank) informing the beef exporter as to the credit and the required documents to be presented to its bank. If the price of the advance-purchase contract and the value of the beef export contract are different, the balance will be liquidated in the light of the agreement or by way of later arrangement if the agreement has no terms in respect of settling the balance.

2.1.2.3. Contractual Arrangements

Since the advance-purchase contract has been undertaken by the advance-purchaser in expectation of being able to export, the contract should include a commitment that the advance-seller will buy certain products from the advance-purchaser in accordance with the details specified in the contract. To achieve security, the parties should add that the proceeds of the advance-purchase contract are to be allocated to be used as the basis for the issuance of a counter-letter of credit. The contract should also specify that both letters of credit are to be opened and administered in strict compliance with the specifications set out in the contract. Moreover, the contract should contain necessary steps needed to open and to administer both letters of credit.

There are two methods by which the advance-purchaser may control the proceeds to be properly allocated for its own export. i) The parties may agree in their contract that the proceeds are payable to the advance-seller only if documentary proof of the issuance of a specific letter of credit in favour of the advance-purchaser has been presented to the bank. This kind of contract should contain details of the letter of credit needed to be opened by the advance-seller as the pre-condition of claiming payment of its own sale. ii) The parties may arrange that the advance-seller has to present, among other documents, an irrevocable instrument that all proceeds are to be blocked to be used as the basis for the issuance of a letter of credit in favour of the advance-purchaser. If this method has been chosen, the contract should contain details of the irrevocable instrument to be presented by the advance-seller to its own advising bank. They usually include the bank where the money should be blocked, the time period when the funds are to be frozen, the details of the letters of credit in both directions, and the documents needed to be presented by either party to its own advising bank to claim payment.[140]

Since the proceeds of the advance-purchase contract belong to the advance-seller, the parties, in both methods, should state in the contract the situations where the owner can claim payment, even if the issuance of a counter-letter of credit has not taken place. They may agree that if the advance-purchaser does not ship the goods up to a specified time, the other party can claim payment. They may also arrange that if the advance-seller has been found responsible for not sending the goods, the advance-seller has to pay back a specific percentage of the advance-purchase contract as penalty.[141] In cases where the proceeds of the first and the second letter of credit are not the same, the contract should include some provisions for a method for liquidation. For example, they may provide that after the issuance of the second letter of credit, the advance-seller can claim the amount remaining.

140 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UNCITRAL, New York, 1993) at 100.
141 See above, pages 322ff.

2.2. Satisfying an Imposed Countertrade Requirement

A country may choose to mandate countertrade for a variety of reasons. Under such a policy the country makes the import of certain foreign goods dependent on the seller's purchase of domestic products so that an export-import equilibrium can be achieved. In this situation, a company is not able to export certain products to the country, unless it undertakes to counter-export certain domestic products in return. In a number of cases it is advantageous to the exporting company to fulfil its counter-export commitment prior to its own export. Some companies that have an established importing relationship with such countries may also want to take advantage of the situation reserving their rights to export equivalent amounts to these countries. In these circumstances, the advance-purchase contract has been entered into to meet a countertrade requirement imposed by a foreign government. The main concern for these companies is to ensure that they will be able to export to such countries.

2.2.1. International Trading Certificates

A mechanism has been initiated in the US by General Foods Trading Company and the Bank of Boston to regulate the process of advance-purchasing.[142] Under this method, the advance-seller issues a documentary instrument, called the *International Trading Certificate* (ITC), giving the holder an irrevocable right to export goods or services to the endorsing or accepting country.[143] This method has two objectives: certainty of the later export to the country and

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142 Mackiewicz, "International Trade Certificate Promoted by Bank of Boston" (December 21, 1984) *The American Banker* at 2.

143 "General Foods, Bank of Boston Hoping New Finance Instrument Will Ease Countertrade" (January 2, 1985) 2(1) *International Trade Reporter* at 19; available in Lexis-Nexis, News Library.

transferability of this instrument to third parties. David Cookson of the Bank of Boston said: "We believe it will do for countertrade what letters of credit did for the international credit market several decades ago."[144] This experience could be of assistance in cases where an advance-purchase contract is entered into as a precondition to access a foreign market.

2.2.1.1. How International Trading Certificates Work

The following example illustrates how *International Trading Certificates* might work for countertraders. Suppose the Chinese Government for some reason mandates that exporting companies which export manufactured products to China must counter-purchase some Chinese goods to counter-import. Suppose further that an Australian company expecting to export some manufactured products to China considers it more advantageous to purchase some Chinese products in advance. Alternatively, the Australian party may be an importing company which has an established relationship with China preferring to continue purchasing from China in spite of its relatively higher prices. The mandated countertrade in China gives an opportunity to the Australian importing company to compensate for some expenses incurred as a result of disadvantageous prices through reserving a right to export to China. The Australian advance-purchaser needs to ensure that it will be able to export manufactured products equivalent in value to the advance-purchase contract. The Chinese advance-seller may issue an *International Trading Certificate* giving the holder an irrevocable right to export manufactured products to China up to the amount set out in the document. Since the obstacles in the way of exporting manufactured goods have been imposed by the Chinese Government, the Central Bank of China or another government

144 Mackiewicz, "International Trade Certificate Promoted by Bank of Boston" (December 21, 1984) *The American Banker* at 2.

agency must endorse such a document. Involvement of a third bank (in this example, an Australian bank) is beneficial in preventing counterfeiting and increasing the worthiness and reliability of the ITC in the marketplace. This certificate may be used to export manufactured products by the advance-seller itself or it may be sold to those exporting companies looking for a way to export manufactured products to China without undertaking a counter-purchase commitment.

2.2.1.2. Contractual Remarks

The issuance of a trading certificate as an instrument facilitating the advance-purchase process may not be well known in many countries demanding countertrade. It also lacks an internationally established precedent. It is for the parties to discuss the advantages and procedure of ITCs with these governments. The contract and the certificate should be drafted as completely and clearly as possible. The advance-purchase contract may be drafted as a normal sale contract under which certain products have been purchased against cash. Since advance-purchase has been entered into in expectation of satisfying a countertrade mandate, the ITC should be drafted in such a way that the later export will be well ensured in the benefit of the advance-purchaser. The advance-purchaser should take into account the following factors if an ITC is to be used:

i) In cases where countertrade is mandated by a government, its details and the conditions upon which a counter-purchase of domestic products will be perceived as the fulfilment of the requirement should be carefully investigated before drafting any contract. A government may mandate countertrade through export-import regulations whereby import licences are given to those firms undertaking a counter-export commitment. Alternatively, such a demand may be imposed through financial policies whereby the allocation of hard currency is only made to those exporting firms undertaking countertrade. In both cases it must be determined that when domestic products are purchased in advance, the government will give an import licence or allocate sufficient hard currency. In these circumstances, the certificate issued by the advance-seller should be endorsed by a relevant government agency authorising irrevocably the holder to export certain products to the country or by its central bank agreeing that sufficient hard currency be allocated for the holder's export. Without such an endorsement the ITC or any other certificates may be worth nothing.

ii) The country requiring countertrade may put restrictions on the types of products permitted to be imported into the country, on their quality and quantities, on their sources of origin, on the third parties to whom the certificate may be transferable, or on the time for executing exports. Such restrictions limit the use of the certificate as a marketable trading instrument.[145] The more limitations and conditions imposed on the certificates, the less the chance to re-sell them in the marketplace. It is a matter of negotiation to get the trading certificates as unqualified as possible. Thus, before finalising the advance-purchase contract, it is advisable to find out any restrictions that might be imposed by the central bank or other government agencies when endorsing an ITC or a similar certificate. The participation of a representative from the relevant government agency in negotiations facilitates the agreement, saving time and money.

iii) The involvement of a third bank will institutionalise the marketability, transferability and acceptability of ITCs. The role of the third bank is to confirm the validity of the certificate

145 "General Foods, Bank of Boston Expect New Finance Certificate Will Boost Trade" (December 10, 1984) 237 *Daily Report for Executives*, Section: International Finance at 1; available in Lexis-Nexis, News Library.

against counterfeiting, authenticating the document and backing it up with credit. The bank may also sell and buy these trading certificates as a broker. In cases where ITCs are issued to ensure the payment of hard currency, the bank may guarantee the payment.[146] The Bank of Boston has established a specific network to deal with *International Trading Certificates*.[147] The advance-purchaser holding an ITC transfers the certificate to the bank. The bank then looks for exporting companies trying to export to that country and faced with a countertrade demand. The value of the ITC is determined in accordance with the law of supply and demand.

iv) A trading certificate should clearly indicate that the holder has a right to export to the endorsing country and to be paid in hard currency. It is beneficial if the certificate provides that giving such authorisation is independent of the underlying advance-purchase contract, a matter that expands its marketability and brings it close to other paper transactions such as bills of lading and letters of credit. The types of products to be imported, their quantities, their values and other specifications also need to be mentioned in the certificate. The value of products may be equal to value of the advance-purchase contract or constitute a percentage of it.[148] The other important issue is the expiry date of the certificate. The longer the time given to the certificate, the greater its acceptability in the marketplace.

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146 Boliek, "International Trading Certificates" in Korth (ed), *International Countertrade* (Quorum Books, New York, 1987) at 107.

147 As above.

148 Elderkin & Norquist, *Creative Countertrade: a Guide to Doing Business Worldwide* (Ballinger Pub, Cambridge, 1987) at 72.

3. Debt-For-Export Swaps

3.1. Overview

An exporting party who has already sold some products to an importing party under a normal method of trade may be required by the importing party to be paid in kind. Although the exporter undertakes no obligation to purchase from the importing party, the exporter needs to do so because the importing party has no hard currency to meet its payment obligation. Under this mechanism, the exporting party purchases some products from the importing country in exchange for its debt. This section will discuss the exchange of debt for goods in a broader sense to cover all cases where debts are to be paid through products, irrespective of whether or not the source of debt is an export contract.

The 1980s witnessed the emergence of goods-for-debt swaps as an innovative method of countertrading in international business. In 1983 the Peruvian Government began goods-for-debt arrangements with Moscow.[149] Later in 1987, Peru used them more widely with US and other international creditor banks. The scheme has spread very quickly through Latin American and other lesser developed countries. Today, this method is a notable option for those countries facing large debt burdens to reduce their loan portfolios without further payment in hard currency. Debt-for-export swaps, goods-for-debt deals or debt for trade schemes, whatever they may be called, are mechanisms under which the external debt is retired through products rather than cash. Lacking any kind of standardisation, these arrangements are negotiated and drafted on a case-by-case basis. Despite the variation of

149 *Inter Press Service* (August 31, 1987); available in Lexis-Nexis, News Library.

the debt-for-export schemes, there are some elements which are common in most of these transactions. A brief discussion of key elements of this kind of countertrading provides an outlook for better understanding of transactions entered into on a debt-for-export basis.

3.2. Key Elements of Debt-for-Export Swaps

i) Since the loan usually has to be retired through cash, the creditor has no obligation to accept any suggestion regarding repayment of the debt through products. The debtor must repay the loan in accordance with the loan agreement which is usually free from any stipulation allowing the debtor to pay off the debt through products. Nevertheless, although the creditor is not legally required to purchase products, the creditor may find it advantageous to enter into a countertrade deal to recover its outstanding debt. A request for debt-for-export swaps is usually preceded by the situation where the debtor has ceased making payments on its loan, adopting some measures to relieve the debt burden.

The engagement of the international banking community in such conversion programs was preceded by the world debt crisis which began in 1982. US bankers, for example, agreed to countertrade Peruvian goods for debt in 1987, because Peru had not been servicing its bank debt since 1985.[150] Debt-for-goods swaps offer an opportunity both to banks, which want to receive their outstanding loans, and to the debtor countries, which are seeking to ease their loan burden without spending valuable foreign currency reserves. Sometimes the program is so advantageous to creditors that they put fierce pressure on a debtor country to

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150 *Financial Times* (June 4, 1990) at 27; Luis Alva Castro, the Peruvian Prime Minister at the time, said in a speech: "The idea is that those [creditors] willing to accept goods will receive greater payments than those who are only willing to accept cash remittances." *Reuters North European Service*, (January 19, 1987) available in Lexis-Nexis, Financial News Library.

lift the ban on debt-for-export projects allowing foreign purchasers to pay for goods through buying the country's debt in the secondary market and surrendering it to its central bank.[151] It is a concern, however, that if a creditor agrees to a debt-for-export deal, a similar favour may be requested by other debtors on the basis of sharing clauses and the *pari passu* included in most syndicated loan agreements.[152]

ii) In cases where the creditor agrees to enter into a debt-for-goods conversion, a subsequent arrangement needs to be drafted so that the purchase from the debtor country is efficiently linked to loan repayment. Since the loan agreement is free from any kind of countertrading terms, the subsequent arrangement must include any clauses which are necessary to connect the purchase contract to loan repayment.

iii) The creditor may agree to help the debtor party to export its products to a given market. This assistance ranges from providing marketing facilities and knowledge to finding buyers for the debtor party's products. In return, a percentage of the proceeds generated by the exports will be allocated to service the loan. Under a debt-for-export deal, for example, the First Interstate Trading Corporation, a wholly-owned subsidiary of the First Interstate Bank, agreed to find buyers in the United States and elsewhere for Peruvian products. The proceeds of the export sales have been used to buy off a certain portion of Peruvian debt with the bank.[153] In a similar arrangement, Britain's Midland Bank agreed to arrange for the sale of Peruvian goods with a value of around $23 million in international markets. From the proceeds, $8.8 million were used to cancel loans to Midland and the rest paid to

151 For example, in 1988 such pressure was put on Mr Mailson da Nobrega, Brazil's Finance Minister, to lift his ban on debt-for-export programs. *Financial Times* (November 4, 1988) at 3.

152 United Nations Centre on Transitional Corporations, *Debt Equity Conversions: A Guide for Decision-Makers* (UN, New York, 1990) at 15.

153 *Inter Press Service* (August 31, 1987); available in Lexis-Nexis, News Library.

Peru in cash. Under this arrangement, 40 percent of the proceeds was paid to Midland, and the remainder remitted to Peru. [154]

iv) The creditor may agree to buy domestic products from the debtor country up to a portion of its loan. Unlike the above cases where the creditor facilitates the export sales, here the creditor purchases domestic products from the debtor party. These arrangements call on the creditor to purchase certain products as a goods-for-debt conversion. In a recent deal, for example, Iran agreed to purchase seven French-designed Super Puma helicopters from Indonesia under a goods-for-debt scheme. Under the agreement, the helicopters, which are said to be worth $98 million, were supplied by Indonesia to pay off some of its $120 million debt to Iran.[155]

v) In cases where the loan is between two governments, the debt-for-export arrangement may call on the creditor to purchase certain products from the debtor country on the condition that of every $3 spent on purchases $1, for example, will be repaid in return for the given loan. For instance, under debt-for-goods arrangements concluded between Peru and the former Socialist Bloc in order to reduce Peru's $2 billion foreign debt to these countries, on every three dollars of Peruvian goods purchased by them, one dollar would be allocated to service the debt and the remaining two dollars would be paid in cash to the Peruvian government.[156] When debts are owed by private companies, the two governments concerned may not be able to conclude any official agreements to exchange debts for goods.

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154 *Financial Times* (April 20, 1988) at 5.

155 *International Trade Finance* (July 2, 1993) Section Finance/Business; available in Lexis-Nexis, News Library.

156 *WorldPaper* (September, 1989) Section High-Tech Dollar at 10; available in Lexis-Nexis, News Library.

For example, a debt-for-goods swap proposed by Russia was rejected by the Japanese Government on the ground that the debt belonged to private companies.[157]

vi) The debt-for-export agreement may allow the creditor to sell the debt in a secondary market to those who want to import from the debtor country.[158] Although varying in detail from arrangement to arrangement, the program essentially involves an importer buying an indebted country's external debt that is being traded on the secondary market at a discount, say, for example, at 45 percent of its face value. Some Latin American and African nations have allowed export of non-traditional products by accepting their own debt as payment. The debtor country's central bank then will pay the domestic exporters for their goods in local currencies. In some cases the central bank accepts the debts only at a discount on their face value. Alternatively, the central bank may honour payment of the debt's full face value in local currency, but at a lower rate. At times, a combination of cash and debt is requested by the central bank. For example, Sudan, Peru and Bolivia are among heavily indebted nations which, having exported raw material commodities, have accepted a combination of their own debt and cash as payment.[159] Since from time to time a given country may change its policy regarding acceptance of its own debt as payment of its exports, the involvement of its central bank in loan conversions is essential. In Bolivia and Peru such permission has been given on a case-by-case basis.[160]

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157 *Information Access Company* (July 4, 1994), available in Lexis-Nexis, News Library.

158 Since the world debt crisis of 1982, a secondary market for trading debt of indebted countries has arisen. This market involves swaps of debts at discounts ranging from twenty to ninety percent of their face values, depending on the economic position of the debtor country. Stuber, "The Brazilian Debt-Equity Swap Program" (1989) 12 *Hastings International & Comparative L Rev* 613 at 614.

159 *Heritage Foundation Reports* (January 21, 1987) Section Debt/Equity Conversion; A Strategy for Easing Third World Debt, at 1; available in Lexis-Nexis, News Library.

160 As above.

vii) In cases where a debt is traded at a discount in a secondary market to be used for export sales payment, the practice may result in a cheaper export for debt purchasers in comparison with other exporters. Fiat do Brasil SA, a Brazilian car exporter, for example, considered a debt-for-goods conversion as a way of reducing its export costs, while remaining competitive in the international car market.[161] It is a concern, however, that such a practice would badly affect international trade, granting unfair advantages to debtor's exporters against other competitors in the world market, a matter which is discouraged by the Word Trade Organisation (WTO) and the General Agreement on Tariff and Trade (GATT). One Brazilian opponent of the practice said: "I am against debt for exports. Why should an inefficient exporter be helped? If you believe in the free market, you can't support this idea. It's just not good economics".[162] When such a debt conversion occurs outside the indebted country's mandates, claiming a breach of the GATT is difficult, because the GATT is a contract between governments, imposing no direct obligations upon the citizens.[163]

viii) One of the problems associated with debt-for-export swaps is the kind of goods and commodities that are available for conversion. One fundamental reason underlying debt swap demands is the export of products which are difficult for the debtor country to change to hard currency in a given market. As a result, goods easily marketable for hard currency may be excluded from the deal. At times, the list covers a combination of desirable goods, such as minerals, and undesirable goods that are less marketable.[164] In some cases, however, a debtor country resorts to debt-for-goods schemes to use the market facilities of the creditors which by no means implies inferiority of the goods. In a debt swap between

161 *Financial Times* (June 28, 1988) at 5.
162 Lake, "Debt Swap Plan Would Subsidise: Brazil's Exports With Loan Sales" *American Banker* (August 19, 1988) at 2.
163 See Chapter 10, pages 413ff.
164 *Financial Times* (June 4, 1990) at 27.

the First Chicago Corporation and Peru, for example, \$20 million of debt was cancelled in exchange for coffee, textiles, alpaca, beer, canned vegetables and frozen fish.[165] In another debt-for-goods swap with the First Interstate International Bank of California, Peru exported \$14m of textiles, fish products, shrimp, jewellery and ferrous metals.[166] To guarantee a reliable supply of more marketable products, the creditor may need to gather information about different producers in the debtor country prior to finalising a debt swap.

ix) From the viewpoint of creditor banks, debt-for-goods schemes are perceived as a vehicle for recovering their outstanding loans. They agree to purchase only as a way of recovering at least part of their loans. As a result, they have a keen interest in legally linking the purchase to loan retirement. On the other hand, they may want to limit their responsibilities as regards the purchase to do their best in finding buyers or providing marketing facilities and so on without being legally bound to purchase. Alternatively, a creditor may agree to purchase some products to cancel a loan only if marketing situations are advantageous. In these circumstances, creditors may wish to establish a framework to ascertain the possibility of retiring their loans through purchasing products without being obliged to do so.

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165 *Chicago Tribune* (May 2, 1990) Section Business at 5; available in Lexis-Nexis, News Library.

166 *International Trade Finance* (June 29, 1989) Section Finance/Business; available in Lexis-Nexis, News Library.

Conclusion

In some cases, an exporting party may not be able to sell or to access to its money unless it undertakes to purchase some products from the importing party in return. Under a typical counterpurchase arrangement, the exporting party sells certain products to an importing party and agrees in return to counter-purchase some domestic products from the importing party. In advance-purchase practices, an exporting party purchases in advance some products from an importing party to meet a countertrade obligation imposed by the importing party. Debt-for-export swaps includes those cases where an exporting party purchases some products from an importing party in exchange for its debt owed by the importing party. Since in these practices a purchase is undertaken by the exporting party for the purposes of its own exports, the exporting party has a substantial interest to ensure that such a purchase is appropriately linked to its own exports. This chapter has focused on the key issues which should be included in counterpurchase, advance-purchase and debt-for-export swaps to ensure that by undertaking a purchase obligation, the exporter facilitates its own exports. In these three practices the exporting party is required to purchase some goods which are not related to subject matter of the primary export contract. The next chapter will focus on cases where the exporting party agrees to buy back the resultant output of the goods or services exported.

CHAPTER 9

Buy-Back and Build-Operate-Transfer

Introduction

The focus of this chapter is on those countertrade arrangements under which an exporting party exports materials, technology, equipment and plant facilities and agrees in return either to buy back the resultant output or to be repaid by the proceeds generated from the plant. Under a buy-back arrangement, the exporter of technology and equipment agrees to purchase back a certain percentage of the products manufactured by the use of the technology and equipment. In Build-Operate-Transfer (BOT), the exporter of capital goods, machinery and technology constructs a project on the condition that the exporter will operate and exploit the project for a predefined period of time in exchange for the costs incurred. A buy-back or BOT package may contain different contracts which are needed to be linked to each other under a framework agreement. This chapter will address the main issues which should be considered in planning and drafting these arrangements under two subheadings of buy-backs and Build-Operate-Transfer.

1. Buy-Backs

Under buy-back arrangements, one party exports machinery, equipment, patents, know-how and technical assistance in order to set up a production plant while undertaking in return to buy a certain portion of the goods that will be produced or manufactured there. In typical buy-backs, a preliminary agreement is entered into as a framework for the rights and obligations of the parties. I will call this preliminary agreement the *buy-back contract*, the exporter of equipment and technology the *supplier*, the importer of the equipment and technology the *purchaser*. In addition to the buy-back contract, at least two more contracts will be entered into by the parties. The first contract is an export contract by which the supplier sells machinery, equipment and technology to the purchaser in order to build and set up a plant. I will call this contract the *primary contract*. The second contract, which I will call the *purchase contract*, is a contract by which the supplier buys a certain portion of the goods manufactured or produced in the plant set up through its assistance.

The buy-back contract may be entered into prior to both the primary and purchase contracts or simultaneously with the primary contract. If the buy-back contract is to be concluded prior to both contracts, it will need to cover the key issues of both contracts plus the issue of linkage between the supply of machinery and the buy-back commitment. If the buy-back contract is to be entered into simultaneously with the primary contract, the buy-back contract will need to deal only with the issue of linkage and the key issues of the purchase contract while leaving the issues related to the primary contract to its own contract. Concluding the buy-back contract concurrently with the primary contract is preferable because the parties are able to draw up the terms of the primary contract in a precise and definitive way. This will increase the possibility of its enforceability under various legal systems.

The key issues in drafting buy-back arrangements, irrespective of the format chosen, can be grouped into four categories: i) the supply of equipment and technology (the primary contract); ii) commitment to buy back the output (the purchase contract); iii) the issue of linkage between these two sets of obligations; and iv) the issue of adaptation of contractual terms which may be related to either direction.

1.1. Issues Related to the Primary Contract

1.1.1. The Kind of Assistance

In buy-back programs, one party (the supplier) has expertise and facilities in a given field. It undertakes to assist another party (the purchaser) in setting up a productive plant and agrees to buy back a certain portion of the goods produced there. Such an undertaking varies from case to case ranging from providing some technical assistance to building a complete plant which may involve the supply of machinery, technology, management services, know-how and licences. The facilities and expertise provided by the supplier may lead to setting up a factory, establishing a refinery, updating an existing plant, exploiting mines, erecting oil or gas pipelines, or even improving agricultural industries. This assistance may be grouped under three major headings: construction, supply of machinery and materials and transfer of technology.

1.1.1.1. Construction

The buy-back program may involve the construction of industrial works, engineering and installation. In these arrangements the supplier undertakes to build and equip a plant such as a factory, an airport, a dam or a refinery in the purchaser's country. Construction may include the supply of materials and equipment, carrying out the work, installation of equipment, or supervision of installation. There are three issues of great importance to be included in the buy-back contract with respect to construction. The first essential element which needs to be described in the buy-back contract is the scope of the work which the supplier is required to perform. The second key element is the amount of payment to be made by the purchaser. The last element relates to establishing a variation mechanism for cases in which implementing certain changes as to the quantity and quality of the work may become necessary during the course of construction.

Scope of the Work

The scope of construction and the technical specifications of the work should be defined clearly in the contract. The scope of the work, the details of the plan, the materials to be incorporated, the equipment to be used, the standard of the work, the extent of each party's participation in the construction and the after-construction services all need to be specified in the contract.[1] The distinction between a construction arrangement under buy-back and other construction arrangements is that the constructor (the supplier) must buy back a certain quantity of the output in return. Since the operation of the project and quality of the

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1 UNCITRAL, *Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (UN, New York, 1988) at 54; Macdonald & Palmer, "International Construction Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 93-98.

output are significant for both the parties involved, they need to cooperate with each other in determining the details of the project.

If the scope of the work is the complete structure of the plant, the supplier has to undertake everything needed for completing the plant to hand it over in its entirety to the purchaser. In these arrangements, known as *turnkey,*[2] the obligation of the supplier includes designing, supplying materials and equipment, building, erecting, commissioning, and start-up to the point that the project can be handed over fully-operational to the purchaser.[3]

In cases where the construction is to be completed jointly with the participation of the purchaser, the contract should specify in detail the accommodation, equipment and services which are to be supplied by the purchaser. Lack of precision in describing the obligation of each party and failure to define the exact contribution of the purchaser invariably result in disputes as to the extent of either party's obligation. The sequence of work and the coordination of the parties if they are to work at the same time on one site, should also be managed in the contract.

When the supplier has to undertake only part of the work, it has an interest in fixing specifications of others' work and in supervising their construction process because the supplier has to purchase back a portion of the output. For example, if the purchaser or a third party has to prepare the plans, or to supply materials or equipment, the contract should contain designs, drawings, data or other specifications according to which the plans are to be prepared or materials and equipment are to be supplied.

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2 The term *turnkey* was not considered as a term of art in *Cable v Hutcherson* (1969) 123 CLR 143 at 151.

3 Macdonald & Palmer, "International Construction Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 88.

In some cases, the supplier undertakes to perform certain obligations even after construction. These after-construction services may include supply of spare parts, maintenance and repairs, training and providing operational assistance.[4] The kind of spare parts, their availability, the pricing procedure and the length of obligation should be specified in the contract if the purchaser has an interest in acquiring spare parts from the supplier. Providing maintenance and repairs is of great importance in keeping the project operating, especially when the project involves technology which is not disclosed to the purchaser or a third party. A maintenance schedule needs to be established for inspections, cleaning, replacement of defective parts and the like. The extent of repairs, the time-frame for repairing, and the procedure for pricing repairs are the key issues to be addressed in the contract.

The purchaser may also want to ensure that the plant will operate smoothly and reach its production targets using the purchaser's personnel. Under this arrangement an obligation is imposed on the supplier to transfer to the purchaser's staff the necessary skills and knowledge needed for a successful operation. This training program may be scheduled during the maintenance period when the supplier has to maintain the work to the satisfaction of the purchaser. The supervision of the supplier over the operation is a matter which may be requested equally by the supplier and the purchaser. By keeping its eyes on production, the supplier ensures that the goods to be bought back meet the standard requirements of the world market, a matter which is of a great importance for their marketability. As a result, the contract should define carefully the scope of engagement of the supplier in the operation, the kind of assistance to be provided, the personnel needed to

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4 At 279.

be supplied by the supplier, the procedure for determining the costs and the duration of providing operation services.

The Amounts of Payment

The payment to which the supplier will be entitled depends on the scope of work to be performed. The pricing systems most often used in construction contracts are *fixed price*, *unit pricing* and *cost plus a fee*.[5] The fixed price method, under which the supplier undertakes to construct the project for a lump sum, is generally used when the extent of the work is sufficiently known.[6] Under this method, the price will remain constant despite any fluctuation in costs or additional costs incurred, unless otherwise agreed. In the unit pricing method, the whole price is calculated with reference to a schedule of rates agreed by the parties.[7] The unit may refer to units of materials used, units of time spent or units of work completed.[8] In this method, therefore, the price is to be calculated according to the number of units listed in the contract with their rates and prices. Under the *cost plus a fee* method, the total price will be set at the time of completion with reference to the actual costs incurred by the supplier plus a fee. That fee may be a fixed fee or a percentage of the actual costs.

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5 Stokes, *International Construction Contracts* (McGraw-Hill Publications, New York, 1981) at 48.

6 Macdonald & Palmer, "International Construction Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 98.

7 In *Arcos Industries v Electricity Commission* [1973] 2NSWLR 186 at 193, Jacobs P remarked:

> The reason for having a schedule of rates contract is that the extent of the work cannot at the outset be predicated so that a contract price may be firmly stated. The nature of the work is certain, but its extent is not. The work must be completed, but the extent of it depends on information not available at the contract stage.

8 UNCITRAL, *Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (UN, New York, 1988) at 83.

Due to the complexity of international construction contracts, it is difficult to fix the price for the plant, once and for all, at the time of concluding the contract.[9] Instead, a procedure needs to be established so that the price can be revised from time to time if certain predefined events occur.[10] These events include situations like fluctuation in costs and wages, natural disasters, hardship, and changes in local regulations or decrees. A price adjustment clause is important for peace of mind especially in circumstances where the occurrence of enumerated events is likely.[11]

The time at which the supplier is entitled to payment is another issue which should be agreed on in the contract. In the absence of agreement, if the supplier has undertaken to perform the entire work, it becomes entitled to payment upon completion of the work.[12] An obligation to perform specific work, such as building a bridge, is a case in which the obligation is entire and indivisible. Nevertheless, if it is held that the work is divisible, the supplier will be entitled to payment accordingly. Whether a contract is entire or divisible depends on the content of the contract and all the surrounding circumstances.[13] To avoid uncertainty, the parties should provide expressly whether or not the obligation to pay is conditional upon completion of the work.

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9 Van Deventer, *The Law of Construction Contracts* (Chancery Law Publishing, London, 1993) at 102.

10 Clark, "Drafting International Contracts in the Engineering and Construction Industry" (July 1968) *The Business Lawyer* 983 at 990.

11 See below, pages 387ff.

12 In *Baltic Shipping Company v Dillon* (1993) 176 CLR 344 at 350, Mason CJ said:

> An entire contract or, perhaps more accurately, an entire obligation is one in which the consideration for the payment of money or for the rendering of some other counter-performance is entire and indivisible.

13 In *Amoco Australia v Rocca Bros Motor Engineering* (1975) 133 CLR 331 at 341, the Privy Council said:

> As Kitto J. remarked in *Brooks v. Burns Philp Trustee Co. Ltd.* (1969) 121 CLR 432, at p 438, 'questions of severability are often difficult'. The answer depends on the intention of the parties as disclosed by the agreement into which they have entered.

Variation Procedure

A need for variation during the progress of construction as to the design, method or sequence of performance, and technical features of equipment and materials is inevitable, particularly in projects of significant size.[14] Over the life of the contract, either party may believe that the works demand some modification in progress or quality. It is therefore advisable to set up a mechanism for managing requested changes or variations. The mechanism should provide a basis for acceptance or rejection of any change sought by the parties. For example, they may agree that all variations suggested must meet certain criteria or must be within the limits set forth in the contract. The mechanism may also specify a procedure for a quick settlement of disputes arising in this respect. The mechanism should also fix a way for adjusting the price, time for completion, warranties and so on in accordance with the changes implemented.[15]

The Use of Standard Forms and General Conditions

Apart from those issues mentioned in the above paragraphs, there are still many details which need to be managed before finalising the deal. It is often difficult for the parties to complex contracts like industrial works to anticipate all contingencies, inserting appropriate terms correspondingly. In these circumstances, the use of pre-prepared forms and general conditions as a base for the contract is widespread at both the domestic and international levels.[16] The following four forms are currently being used in Australia for construction and

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14 Stokes, *International Construction Contracts* (McGraw-Hill Publications, New York, 1981) at 94; UNCITRAL, *Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (UN, New York, 1988) at 249.

15 Macdonald & Palmer, "International Construction Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 100-101.

16 See Chapter 6, pages 217-253.

building agreements:[17] i) The *Lump Sum Contract Edition 5b* (Ed 5b) approved by the Royal Australian Institute of Architects and the Master Builders Federation of Australia Incorporation; ii) The *National Public Works Conference, Edition 3* (NPWC3); iii) the *Joint Contracts Committee* (JCC-D 1994); and iv) *Australian Standard 2124* (SA2124).[18]

At the international level a variety of general conditions and standard forms have been prepared and adopted by different international bodies.[19] Those sponsored by the Federation Internationale Des Ingenieurs-Conseils (FIDIC) and the United Nations Economic Commission for Europe (ECE) are more commonly used in international construction deals.[20] Some of these general conditions are:

i) ECE Form 188a, General Conditions for the Supply and Erection of Plant and Machinery for Import and Export;

ii) ECE Form 574a, General Conditions for the Supply and Erection of Plant Machinery for Import and Export; and

iii) FIDIC, Conditions of Contract for Works of Civil Engineering Construction.[21]

In addition to these general conditions, a Legal Guide on Drawing up International Contracts for the Construction of Industrial Works was adopted by UNCITRAL at its twentieth session in August 1987.[22] This legal guide was published in 1988 and effectively

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17 Cremean, *Brooking on Building Contracts* (Butterworths, Sydney, 1995) at 7-8.

18 These standard forms are reprinted in Dorter & Sharkey *Building and Construction Contracts in Australia: Law and Practice* (Law Book Company, Sydney, 2nd ed 1990) at 9701-10115.

19 Macdonald & Palmer, "International Construction Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 91.

20 Schmitthoff, *Schmitthoff's Export Trade* (Stevens, London, 9th ed 1990) at 74-75.

21 These General Conditions are reprinted in Delaume, *Transactional Contracts, Applicable Law and Settlement of Disputes* (Oceana Publications, New York, 1988) Appendix IV, Booklet A, Release 94-1.

22 UNCITRAL, *Yearbook* vol XVIII, (UN, New York, 1987) at 35.

deals with the legal and business issues of construction contracts.[23] It is useful in negotiating and drafting different types of construction contracts.[24] Some illustrative provisions have been set forth in its footnotes to make issues discussed there easier to follow and to provide a picture of drafting contractual provisions.

1.1.1.2. Supplying Equipment and Materials

In some cases of buy-backs, the supplier is to export machinery and materials to be incorporated into a project. Two situations should be distinguished at the outset with respect to these cases. First, the obligation of the supplier is only to provide equipment and materials, while the incorporation of them into the project is to be carried out by the purchaser or by another contractor under the purchaser's supervision. Second, the equipment and materials are to be integrated into the project by the supplier or its sub-contractors.

In the first category, the supply of equipment and materials is a sales contract, even if they are to be manufactured.[25] The buy-back contract should provide a clear description of equipment, machinery and materials to be provided by the supplier. Since in sales contracts the seller impliedly warrants that the goods will be fit for the purpose for which they are required,[26] the parties should precisely specify that purpose in the buy-back contract. Any potential claim as to defects in materials and equipment will be depend on the level of detail specified in the contract. The parties may use INCOTERMS to regulate their relationship

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23 UNCITRAL, *Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (UN, New York, 1988).

24 Perlman, "Legal Guide on Drawing up International Contracts for the Construction of Industrial Works" Book Review (1990) *84 American J International L* 345 at 345.

25 See Chapter 5, pages 197-201.

26 Article 35 of the Vienna Sales Convention.

as to transport, insurance, passing of risk, obtaining export or import licences and packages.[27]

The second category is more complex because the supplier has to install the materials and equipment in the project. The obligation of the supplier does not finish with their delivery but extends to the point where they will be incorporated into the plant. Although INCOTERMS are primarily prepared in the context of sales contracts, they may still be used to resolve many problems arising in these cases concerning, transport, passing of risk or insurance.[28] The buy-back contract should specify some other issues in addition to description of equipment and materials which are significant in setting the rights and obligations of each party.

The origin of the equipment and materials needs to be fixed, especially when they are also obtainable from the purchaser's local market. It is also important to define the obligation of either the supplier or purchaser as to the transport of equipment and materials to the site, obtaining export and import licences, packaging, and the cost of transport, insurance and customs duties. The contract may also give the purchaser the right to test and examine materials and equipment before shipping, at their place of manufacture or somewhere else.[29]

1.1.1.3. Technology Transfer

A buy-back package may contain some kind of technology transfer necessary for the project to be a productive entity. The supplier may provide technology to the purchaser to produce

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27 See Chapter 6, pages 255-260.

28 UNCITRAL, *Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (UN, New York, 1988) at 101.

29 Macdonald & Palmer, "International Construction Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 96.

or manufacture certain goods, a portion of which is to be purchased back. The contribution of the supplier may be limited only to the technology necessary for production or it may extend also to constructing the project, supplying materials and equipment, training, or other technical support. The buy-back contract should contain as precise as possible a description of the technology to be transferred. When it is difficult to provide a precise description of the technology, the type, quality and quantity of products which are to be produced or manufactured by the use of the technology should be defined.[30] Technology may be transferred through supplying equipment, granting licenses or providing confidential know-how and skills which will be discussed below:

Supply of Equipment

If the technology is crystallised in equipment, the supply of the equipment under the buy-back arrangement is similar to other sale contracts.[31] The supplier may, however, put certain restrictions on resale of the equipment or on its use for other purposes. The supply of equipment generally creates no intellectual rights as to the products manufactured through the use of the equipment, unless otherwise agreed. In some cases, however, equipment is part of a package including intellectual properties and know-how.

Licences

The technology is generally transferred by granting licences. Under a licence arrangement, the owner of a software, patent, trademark or industrial design grants the licensee the right

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30 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 57.

31 Calvert, *Technology Contracts* (Butterworths, Sydney, 1995) at 109.

to use the licensor's intellectual property which otherwise may not be lawful. The licence can be exclusive, sole or non-exclusive according to the rights the licensor retains for itself.[32] When, in buy-back, such a licence is to be granted, there are certain issues which need to be addressed in the buy-back contract. First, the subject matter of the licence should be specified clearly in the contract. It may be a patent, software, a trade mark, a design, copyright or a combination of one or more of these. The details of the licence are to be shaped in the light of the subject matter. Second, the condition of using the licence is another primary issue which should be made clear in the contract. The licensor may impose certain limitations on the use of technology as to territories within which the licence is to be used for production, the purpose for which the licence is to be employed, and the quantity of the goods to be manufactured under the licence. Third, the term of the licence needs to be fixed if it is not to be unlimited. The supplier may grant the licence, such as a trade mark, on a fixed period basis. By the end of that time, the licence will be terminated and consequently the purchaser will no longer have the right to use the trade mark, patent, copyright or software. Fourth, establishing a mechanism to pay for the licence is another key issue which needs to be included in the contract.[33] The payment for the licence may be determined as a lump sum which is either included in the price of the buy-back package or calculated separately. Alternatively, the payment may be fixed in the form of royalties to be payable over the life of the licence in accordance with the number of goods produced or sold by the purchaser.

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32 Under an exclusive licence, the licensor gives up its right to grant similar licences to someone else while retaining its right to use it itself. In the sole licence even the licensor is precluded from using it itself. The non-exclusive one, however, puts no restriction on the licensor granting others similar licences. Lew, "International Licensing Contracts" in Lew & Stanbrook (ed), *International Trade: Law and Practice*, vol I (Euromoney Publications, London, 1990) at 77.

33 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 72.

Know-How

The technology may be transferred through providing know-how and skills to the purchaser.[34] One or more enterprises may possess technology and may not want or are not able to protect their technology by means of registration processes like patents, copyright, trade marks and industrial designs.[35] In such circumstances, they prefer to provide the technology through know-how to keep the information confidential.[36] The need to arrange a clause according to which the purchaser has to keep the information and skills confidential is of high-priority in a know-how arrangement. A definition of information to be kept confidential, restrictions on its disclosure, limitations on its use, the persons to whom such disclosure might be permitted, and the situations leading to the right of termination are some key issues which should be included in the contract.[37] In addition to confidential aspects of know-how which require their own arrangement, the issues mentioned above in relation to licences are similarly applied to the know-how arrangements.

1.1.2. Payment Arrangement

The assistance of the supplier in setting up the plant in the form of construction, supply of equipment and materials, or transfer of technology is obviously for a payment. Unlike

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34 Sometimes the term *licensing* is also used for know-how arrangements. See for example, Byington, "Planning & Drafting of International Licensing Agreements" (1980-81) 6 *North Carolina J of International L & Commercial Regulation* 193 at 195.

35 In the reports of the meeting of 17 and 18 October 1957, the International Chamber of Commerce said that the term *know how* "can be used to define not only secret formulae and techniques, but also a technique which is connected with patented manufacturing processes necessary to utilise the patent; it can also define practical and special processes and technical knowledge which were developed by a manufacturer during research, and may not yet be acquired by competitors." See Stumpf (ed), *The Know-How Contract in Germany, Japan and the United States* (Kluwer, Deventer, the Netherlands, 1984) at 10.

36 UNCITRAL, *Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (UN, New York, 1988) at 66.

37 Calvert, *Technology Contracts* (Butterworths, Sydney, 1995) at 286-287.

barter deals, payment for goods and services supplied under the primary contract of a buy-back package is not directly linked to payment for the output in the sense that equipment and materials swap with the resultant output. There is always a considerable gap between the time of the supply of equipment and the time of buying back the resultant output which requires two parallel money transactions for the supply of equipment and the buying back of the output, especially if this gap is indeterminate at the time of concluding the contract. Moreover, linking these two payments to each other is often not welcomed either by the supplier or by banks.[38] As a result, the purchaser has to arrange in one way or another for payment of equipment and technology provided by the supplier.

In many cases, however, the purchaser has no funds to finance the project and is looking for some kind of financial support from the supplier. If the supplier has sufficient funds and wants to finance the deal, it may allocate credit to the purchaser to be used to finance the project. Repayment of the loan may be made under a schedule or delayed until the output is purchased by the supplier. This type of financing is a kind of indirect investment which ensures that the supplier will see a return on its investment. Since the equipment and materials supplied are valuable, the supplier may use them as security for protecting itself against potential non-payment.[39] The supplier may also reserve the right of disposal of the equipment and materials until the price has been paid to secure the payment.[40]

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38 UNCITRAL, *Legal Guide on International Countertrade Transactions* (UN, New York, 1993) at 94.

39 Brown & Franklin, *Countertrade Paying in Goods and Services* (Longman, London, 1994) at 25.

40 The retention of title, also know as *Romalpa clauses*, is to protect the seller against the non-payment and insolvency of the purchaser. In Australia, the following acts provide a conceptual basis for the operation of the Romalpa clause:

Sale of Goods Act 1895 (SA), s19;
Sale of Goods Act 1923 (NSW), s24;
Sale of Goods Act 1954 (ACT), s24;
Sale of Goods Act 1972 (NT), s24;
Sale of Goods Act 1896 (Qld), s22;
Sale of Goods Act 1896 (Tas), s24;
Goods Act 1958 (VIC), s24; and,

Alternatively, the supplier may have insufficient funds, or no interest in investing in the project. In these circumstances a financial source needs to be found before finalising the contract. One way is to obtain a loan from financial institutions through the support of the supplier. Under one variation, a financial institution provides credit to the purchaser to be used to finance the deal.[41] Under the loan arrangement, the purchaser is to pay off the loan on a schedule. The first repayment may be deferred to the time when the supplier starts implementing its buy-back commitment. Under another variation, however, all payment for the output goes directly to the lending bank by way of credit redemption. Thus, the bank providing credit to make the purchaser able to purchase equipment and technology will be repaid out of proceeds generated by buying back the output.[42] Since there is generally an indeterminate period of time between the supply of equipment and the time when the output is available, the banks are reluctant to agree to this mechanism,[43] without some guarantees given by a government.

Under a third variation, the credit provided by private financial institutions is backed by a government which wants to support the purchaser to buy equipment and technology from its country. Alternatively, such a credit may be provided directly from that government. The loan, which might be part of an aid package to the host country, is to be paid off by the

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Sale of Goods Act 1895 (WA), s19.

See generally, Everett, "Romalpa Clauses: The Fundamental Flaw" (1994) 68 *Australian Law Journal* 404.

41 Under a $5 million buy-back project with Iran, Sante Trading of Cyprus has agreed to supply the Iranian Kraft Food Company with a dried food plant. The project has been financed by the Isle of Man-based Middle East Trading Company to be repaid by resultant products over three years. "Cyprus' Sante Trading Strikes Another Buy-back Deal with Iran" (November 6, 1992) *International Trade Finance*, Section Finance/ Business; available in Lexis-Nexis, News Library.

42 For example, Morgan Grenfell, the UK merchant bank, provided a loan to finance modernisation of the Buddyenovsk polyethylene plant in Russia. The loan was arranged to be repaid out of proceeds from the annual export of 100.000 tons of polyethylene over a nine year period. Silverman, "New Thinking: Current Aspects of East-West Countertrade" (1990) 3 *Annual Conference on Intellectual Property* 4 at 4-30.

43 UNCITRAL, *Legal Guide on International Countertrade* Transactions (UN, New York, 1993) at 94.

revenues made from buying back the output. For example, Germany has given such credit to Russian countertraders who want to purchase equipment and materials from the east part of Germany.[44]

In some cases, the technology is supplied to a country on a leasing basis.[45] Under such an arrangement, a party grants exclusive possession of the technology, equipment and materials to another party for a determined period, receiving the leasing rentals in the form of goods manufactured or produced by those properties.[46] The advantages of establishing the buy-back arrangement on a leasing basis are several. The tax relief which is generally available for leases is one of the advantages of using leases instead of sales.[47] Moreover, the responsibility of supplying equipment, transport and technical installations is taken by the lessor. During the life of the lease, the equipment remains the property of the supplier which gives a higher security to the supplier than the sale of equipment on credit. Maintaining equipment during the time of leasing may be imposed upon the lessor to ensure the quality of the equipment and smooth running of the plant. After the expiry of the lease, the arrangement generally provides a mechanism for transferring the property of the equipment to the lessee.

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44 Bell, "Self Help Financing" 5(4) *Central European,* (April 1995) at 65; available in Lexis-Nexis, News Library. Similar financing has been arranged by Germany to enable Kazak purchasers to purchase coal treatment equipment from Germany which will be repaid by hard currency revenues generated from coal supplied to the German trading partner. *International Trade Finance* (August 13, 1993) Section, Finance/ Business; available in Lexis-Nexis, News Library.

45 Westphalen, "Leasing in Export Transactions" in Horn (ed), *The Law of International Trade Finance*, (Kluwer, Deventer, the Netherlands, 1988) at 327-344.

46 In 1988, a Convention was drafted on International Financial Leasing under the auspices of the UNIDROIT to standardise some aspects of international lease contracts. It has not yet come into force. Goode, "Conclusion of the Leasing and Factoring Conventions" (1988) J Business L 347 at 347ff.

47 Townsend, *Financing of Countertrade* (Butterworths, London, 1985) at 88.

1.2. Issues Related to the Buy-back Commitment

In buy-back arrangements, the supply of technology and equipment is one side of the coin. The other side is a commitment made by the supplier to purchase in return a certain percentage of the plant's output over a given number of years. As a result, the buy-back contract should address the key issues of buying back the output.

Since the commitment to counter-purchase and the commitment to buy back are the same in many respects, many issues discussed in the previous chapter in relation to counterpurchase apply equally to buy-back. These issues include undertaking a commitment to purchase in return, the quality and quantity of products, establishing a pricing mechanism, the penalty clause, the transferability and assignment of the commitment, and marketing restrictions. Since these issues have been discussed at length in the previous chapter there is no need to repeat them here.[48] Nevertheless, there are a few differences which will be highlighted below.

i) Unlike counterpurchase, the goods to be bought back are related to the equipment and technology exported by the supplier. As a result, the supplier knows in advance the kind of products to be bought back. However, if a range of products is to be produced by using the equipment and technology, the parties should clarify the kind of products to be bought back.

ii) In some cases the exact specification of the goods to be purchased back depends on the kind of technology and equipment supplied. In these cases, the supplier may undertake to buy back the goods manufactured regardless of their exact specification. Alternatively, the

48 See Chapter 8, pages 303-332.

supplier may undertake to buy back the goods, even if they are poor in quality or non-standard, if the problem is caused by its technology and equipment.

iii) The buy-back contract may provide that the supplier automatically takes the title of a portion of the output at the time of manufacture without being under obligation to purchase it.[49] By this arrangement, that portion belongs to the supplier and consequently the costs of transport, warehousing, insurance, and exports are on the supplier, unless otherwise agreed.

iv) Since the goods are to be bought back after establishing and operating the project and since it extends over a considerable time, it is necessary to set up a mechanism for pricing the buy-back goods for the duration of the agreement. The UNIDO suggested the following ways of pricing:

> i) Products should be supplied at best market prices plus appropriate commissions;
> ii) Each shipment needs a separate agreement on pricing through negotiation;
> iii) Fix prices on the basis of the calculated price with an escalation clause which would go into force through renegotiations if the deviation would exceed, for instance, + 10%;
> iv) Competitive bidding (offers);... and,
> vi) Periodic price fixing (every 3, 6 or 12 months) could be agreed upon.[50]

If the supplier manufactures the same types of goods, the price of the buy-back goods may be fixed in accordance with the costs incurred by the supplier in manufacturing its own products.

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49 Guyot, "Countertrade Contracts in International Business" (1986) 20 *International Lawyer* 921 at 954.

50 UNCITRAL, "Current Activities of International Organisations in the Field of Barter and Barter-like Transactions: Report of the Secretary-General" (1984) 15 *UNCITRAL Yearbook* 328.

1.3. Issues Related to Linkage

Establishing a clear linkage between the primary contract and the buy-back contract is critical to the long-term status of buy-backs. The issue of linkage, discussed at length previously, is similarly applicable to buy-backs.[51] Two factors are, however, distinct to buy-backs which may result in different legal effects. First the goods undertaken to be purchased back are the output of the plant or technology supplied. Second, the supply of the plant and technology is always made prior to buying back the output. Three additional points need to be made about this kind of arrangement.

i) Since the output is to be purchased back, there is inevitably a connection between the supply of the plant and the commitment to buy back the output. As a result, the supplier has no obligation to buy back goods produced somewhere else. Imposing an obligation on the supplier to purchase back some goods not related to its own equipment and technology needs the agreement of the parties.[52] Similarly, if the supply of plant for whatever reason has not been carried out, the obligation to buy back will also be cancelled. However, in cases where for some reason the primary contract is not fully fulfilled by the supplier and the plant is to be completed by the purchaser or a third person, the parties may want to make it clear whether or not the supplier is still under obligation to buy back the products.

ii) Because the buy-back commitment is to be fulfilled after performance of the primary contract, the failure of the supplier to buy back the goods should not affect the primary contract. Even in cases where the primary contract is still to be completed, it will not

51 See Chapter 7 and in particular pages 298-300.

52 McVey, "Countertrade and Barter: Alternative Trade Finance by Third World Nations" (1980) 6 *International Trade L J* 197 at 216.

always be advantageous to the purchaser to resort to termination of the primary contract if the supplier fails to fulfil the commitment. The parties may want to specify that failures in buying back the goods should not affect in any case the primary contract. To ensure that the supplier will honour its buy-back commitment, the parties may arrange with the financial institution that the supplier directly pays the price of the buy-back goods to the institution. Alternatively, the purchaser may wish to include a penalty clause in the contract for non-performance or delay in performance instead of resorting to the termination of the primary contract.[53]

iii) The linkage between the primary contract and the buy-back contract may be such that the supplier provides equipment and technology and agrees to purchase back the products manufactured there if they correspond to the quality, standards and specification defined in the contract. The supplier, therefore, has no obligation to purchase back the products if they are not in conformity with the agreed specifications, even if the problem of non-conformity arises as a result of the technology and equipment supplied. This arrangement puts the responsibility of maintaining standards, controlling the quality and producing the goods as agreed on the purchaser.

1.4. Adaptation

Economic, financial, technological, political and social changes may take place over the life of the buy-back arrangement and cause adverse consequences for a party, particularly if the arrangement is to be performed over a long period of time. The occurrence of unanticipated changes may make either party's obligation much more onerous than that expected at the

53 See Chapter 8, pages 322-328.

time of concluding the contract. A sudden rise in the price of raw materials or labour, an unusual inflation or deflation of currency referred to in the contract, and the mandate of new regulations about production in respect of environment, safety and health requirements, which increase costs, are examples of situations the consequences and effects of which are basically different from what was intended by the parties at the time of entering into the contract. In response to such events, a revision of the terms of the contract may become necessary in order to adapt the contract to new developments and circumstances. Revision may be required especially with respect to the price, the scope of the work, quality and quantity of goods, and the duration of the performance.

When the question of adaptation arises, the contract may fall into one of the following categories: i) the contract is silent as to the possibility of adaptation; ii) certain terms of the contract are left open; iii) a mechanism for the automatic adjustment of certain contractual terms is agreed on in the contract; and iv) a revision clause is incorporated into the contract.

1.4.1. The Contract is Silent

The parties may fail to provide an agreement in their buy-back contract on adapting the contractual terms to changed circumstances and developments. It is not infrequent in international transactions that the parties are preoccupied with the main issues of the contract so that issues like adaptation are left unmentioned.[54] Alternatively, they may not be able to agree on the circumstances and events to which the contractual terms are to be adapted. Or they may not want to open the possibility of renegotiating and revising the

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54 Bockstiegel, "Hardship, Force Majeure and Special Risks Clauses in International Contracts" in Horn (ed), *Adaptation and Renegotiation of Contracts in International Trade and Financial* (Kluwer, Deventer, the Netherlands, 1985) at 160.

contractual terms after finalising and entering into the contract which is usually preceded by long negotiations. Another concern which may lead the parties to ignore adaptation clauses is the instability and uncertainty which may be caused by inserting such a clause into the contract. It is a concern that by including an adaptation clause, the performance of the contract may be interrupted allegedly on the grounds of changed circumstances.[55]

In cases where the buy-back agreement has no term about adapting the contract to the changed circumstances, the possibility of judicial intervention to adapt the contract depends on the applicable law of the contract. Under the legal systems of countries like Russia, Greece, Hungary, Italy, Germany and Egypt, a party may seek renegotiation of the contractual terms on the grounds of economic hardship and radically changed circumstances.[56] Any failure to reach an agreement to adapt the contract to new situations may give the disadvantaged party a right to terminate the contract.[57]

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55 UNCITRAL, *Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (UN, New York, 1988) at 243.

56 Schmitthoff, "Hardship and Intervener Clauses" (1980) *J Business L* 82 at 83; Horn, "Changes in Circumstances and the Revision of Contracts in Some European Laws and in International Law" in Horn (ed), *Adaptation and Renegotiation of Contracts in International Trade and Financial* (Kluwer, Deventer, the Netherlands, 1985) at 15.

57 Article 451 of the Civil Code of the Russian Federation, (adapted on 21 October 1994) is a good example of a law dealing with materially changed circumstances:

> Article 451. Change and Dissolution of Contract in Connection with Material Change of Circumstances
>
> 1. A material change of circumstances from which the parties proceeded when concluding a contract shall be a grounds for the change or dissolution thereof unless provided otherwise by the contract or it follows from the essence thereof.
>
> A change of circumstances shall be deemed to be material if they have changed such that if the parties could reasonably foresee this, the contract would not have been concluded at all by them or it would have been concluded on significantly differing conditions.
>
> 2. If the parties have not reached agreement concerning the bringing of the contract into conformity with the materially changed circumstances or the dissolution thereof, the contract may be dissolved, and on the grounds provided for by point 4 of the present Article, changed at the demand of the interested party when the following conditions simultaneously exit:
>
> (1) at the moment of concluding the contract the parties proceeded from the fact that such a change of circumstances would not occur;
>
> (2) the change of circumstances has been caused by reasons which the interested party could not overcome after they arose with that degree of concern and care which are required of him by the character of the contract and the conditions of turnover;

By contrast, if the buy-back contract is to be governed by the UNIDROIT Principles,[58] the contract should be performed even though it has become more onerous for one party.[59] However, a party may request renegotiations if such changes fundamentally alter the equilibrium of the contract. The disadvantaged party is entitled to request renegotiations if the occurrence of the events have occurred after concluding the contract and beyond its control which could not reasonably be expected by the disadvantaged party.[60] If the parties fail to reach an agreement on adapting the contractual terms, the disadvantaged party may resort to a court to adapt or to terminate the contract.[61]

> (3) the performance of the contract without a change of its conditions would so violate correlation of property interests of the parties which correspond to the contract and entail for the interested party such damage that it would be deprived to a significant degree of that which it had the right to count on when concluding the contract:
> (4) it does not follow from the customs of business turnover or the essence of the contract that the risk of the change of circumstances is borne by the interested party.
> 3. In the event of the dissolution of a contract as a consequence of a material change of circumstances the court at the demand of any of the parties shall determine the consequences of the dissolution of the contract by proceeding from the need for a just distribution between the parties of the expenses incurred by them in connection with the performance of this contract.
> 4. The change of a contract in connection with a material change of circumstances shall be permitted by decision of a court in exceptional instances when dissolution of the contract is contrary to social interests or entails damages for the parties which significantly exceeds the cost needed to perform the contract on the conditions changed by the court.

Butler (tr), *Civil Code of the Russian Federation* (Interlist Publishing, London, 1995) at 211-212.

58 See Chapter 6, pages 222-228.

59 Article 6.2.1 CONTRACT TO BE OBSERVED:

> Where the performance of a contract becomes more onerous for one of the parties, the party is nevertheless bound to perform its obligations subject to the following provisions on hardship.

60 Article 6.2.2 DEFINITION OF HARDSHIP:

> There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and
> (a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
> (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
> (c) the events are beyond the control of the disadvantaged party; and
> (d) the risk of the events was not assumed by the disadvantaged party.

61 Article 6.2.3 EFFECTS OF HARDSHIP:

> (1) In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds on which it is based.

The Australian courts are reluctant to intervene to adapt a buy-back contract to new changes. The position of the Australian legal system is encapsulated by Viscount Simon in the House of Lords in *British Movietonews v London and District Cinemas* and echoed by Brennan J in *Codelfa Construction v State Rail Authority of NSW*:[62]

> It is of the utmost importance that the action of a court, when it decides that in view of a supervening situation the rights and obligations under a contract have automatically ceased, should not be misunderstood. The suggestion that an 'uncontemplated turn of events' is enough to enable a court to substitute its notion of what is 'just and reasonable' for the contract as it stands, even though there is no 'frustrating event', appears to be likely to lead to some misunderstanding. The parties to an executory contract are often faced, in the course of carrying it out, with a turn of events which they did not at all anticipate - a wholly abnormal rise or fall in prices, a sudden depreciation of currency, an unexpected obstacle to execution, or the like. Yet this does not in itself affect the bargain they have made. If, on the other hand, a consideration of the terms of the contract, in the light of the circumstances existing when it was made, shows that they never agreed to be bound in a fundamentally different situation which has now unexpectedly emerged, the contract ceases to bind at that point - not because the court in its discretion thinks it just and reasonable to qualify the terms of the contract, but because on its true construction it does not apply in that situation.[63]

The position of the Australian law is that the parties must fulfil the contract in spite of changes in circumstances, unless the changes frustrate the contract. In that case, the parties may be relieved from their contractual obligations under the doctrine of frustration.[64]

> (2) The request for renegotiation does not in itself entitle the disadvantaged party to withhold performance.
> (3) Upon failure to reach agreement within a reasonable time either party may resort to the court.
> (4) If the court finds hardship it may, if reasonable,
> > (a) terminate the contract at a date and on terms to be fixed; or
> > (b) adapt the contract with a view to restoring its equilibrium.

62 (1982) 149 CLR 337 at 408.

63 [1952] AC 166 at 185.

64 In *Codelfa Construction v State Rail Authority of NSW* (1982) 149 CLR 337 at 357, Mason J said:

> [A] contract will be frustrated when the parties enter into it on the common assumption that some particular thing or state of affairs essential to its performance will continue to exist or be available, neither party undertaking responsibility in that regard, and that common assumption proves to be mistaken.

Two limitations stand in the way of using the concept of frustration for adapting a contract to new changes. First, the doctrine of frustration has a quite limited scope. In *Codelfa Construction v State Rail Authority of NSW*,[65] Mason J, echoed what was said by Lord Radcliffe in *Davis Contractors v Fareham Urban District Council*:

> [F]rustration occurs whenever the law recognises that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract. Non haec in foedera veni. It was not this that I promised to do.[66]

Because of the narrow scope of the concept of frustration in Australia, frustration does not cover cases where the contract has become burdensome to a party.[67]

Second, the doctrine of frustration gives a right to the party to terminate the contract. The consequence of termination is to relieve both parties from further performance, a matter which is not always welcomed by the disadvantaged party. Section 6 of the *Frustrated Contracts Act* 1988 (SA) provides:

> (1) Subject to subsection (2), the frustration of a contract discharges the parties from all contractual obligations (including obligations that should have been, but were not, performed before the date of frustration).
> (2) The frustration of a contract does not affect-
> (a) an obligation that is, according to the proper construction of the contract, to survive frustration; or
> (b) a right of action, that arose before frustration, for damages for breach of contract (but, in the assessment of any such damages, the fact that the contract has been frustrated and any consequential adjustment, or right to an adjustment, under this Act will be taken into account).

65 (1982) 149 CLR 337 at 357.

66 [1956] AC, 696 at 729.

67 The application of frustration to cases where the performance of contract becomes burdensome is more difficult particularly if it is necessary, as it was in *Davis*, to specify a particular point at which the contract has come to an end. In this regard, Lord Reid said:

> It may be that frustration can occur as a result of gradual change, but, if so, the first question I would be inclined to ask would be when the frustration occurred and the contract came to an end ... I think one must see whether there was any time at which the appellants could have said to the respondents that the contract was at an end, and that if the work was to proceed there must be a new contract, and I cannot find any time from first to last at which they would have been entitled to say that job had become a job of a different kind which the contract did not contemplate.

Davis Contractors v Fareham Urban District Council [1956] AC 696 at 723.

It creates no basis to authorise the parties to seek the adaptation of the contractual terms to new circumstances. As a result, in Australia, if the contract is silent, the changes in surrounding circumstances give no grounds to the courts to adapt the contract or even to terminate the contract, unless the contract is frustrated. This relieves the parties from further performance.

1.4.2. Open Contracts

The other method to deal with changed circumstances is to leave certain terms of the contract open to be determined later. For example, if the supplier is not in a position at the time of concluding the contract to determine its market capacity, the quantity of the goods to be bought back may be left open to be determined subsequently. Two approaches may be taken in drafting such open contracts. First, specific terms of the contract are left open to be negotiated and determined from time to time in the future. In this procedure, the contract requires the parties to negotiate in good faith to reach agreement on the terms left undetermined. Second, a mechanism is established for determining the open terms in the light of circumstances which exist at the time of determination. Such a gap-filling mechanism can be a reference to a third party to fix certain details of the contract. For example, in a buy-back contract, the parties may agree to leave certain details of the construction to a consulting engineer. As stated previously, the courts in Australia will not make the contract for the parties.[68] As a result, if the contract is incomplete and there is no gap-filling mechanism provided in the contract, courts in Australia are reluctant to make the

68 See Chapter 7, pages 287-297.

contract for the parties, or require them to fill the gaps. In other legal systems, these open terms contracts may be completed by the courts.[69]

1.4.3. Automatic Adjustment of the Contract

The parties may agree on an automatic adjustment of certain terms of the contract to keep the contractual terms in line with new situations. In this procedure, the adaptation of the contract to new changes does not depend on the parties' negotiations and agreement. Rather, the adaptation takes place automatically when the elements agreed on in the contract have been changed. For example, the contract may provide the elements of the price. If one of those elements is changed, the price will automatically be adjusted in accordance with the variation taking place. In other words, the parties may agree that the price should be calculated from time to time in accordance with the inflation rate, the cost index of materials or labour, or the value of the contract currency by reference to major world currencies.[70] It is important to define the events which require an automatic adaptation. The parties should base the adaptation on some objective standards which are measurable to avoid uncertainty and disputes.

1.4.4. Revision Clauses

In some cases, the contract requires the parties to review certain terms of the contract, adapting them to new situations. Including a revision clause in the contract gives an

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69 See Chapter 7, page 293ff.

70 These price adjustment clauses are known as escalation clauses. "An 'escalation clause' is the term used for a contract provision which will automatically adjust the contract price in the case of some specified event." Stokes, *International Construction Contracts* (McGraw-Hill Publications, New York, 1981) at 59.

opportunity to the parties to renegotiate the terms of the contract if a material change in the circumstances surrounding the contract takes place. Such a revision may be required on a time basis, such as every three years, or upon occurrence of certain events, like a rapid increase in the cost of manufacturing. In drafting a revision clause, the following considerations should be borne in mind:

i) The parties may agree on the events upon which the revision clause may be invoked. An exhaustive list of the events in the contract reduces the risk of uncertainty inherent in such clauses. Those events may include a considerable increase in production costs, a severe reduction in the size of the supplier's market, a significant change in the technology used in production, and a change in export-import, tax, monetary or labour regulations which adversely affects a party.

ii) The parties may wish to agree on a hardship clause to renegotiate certain terms of the contract if changes in surrounding circumstances make the performance much more onerous to a party. A detailed specification of such changed circumstances decrease the risk of uncertainty surrounding such ambiguous terms. For example, they may provide that such changes must be unexpected at the time of concluding the contract, beyond the control of the party invoking hardship, and having serious adverse economic effects for the party undertaking to perform. The International Chamber of Commerce (ICC) has prepared a standard clause for hardship to be incorporated into such contracts. This standard clause not only requires the parties to participate in renegotiations to adapt the contract but also provides some mechanisms if they fail to reach an agreement as to adaptation.[71]

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71 The ICC standard hardship clause is:

> 1. Should the occurrence of events not contemplated by the parties fundamentally alter the equilibrium of the present contract, thereby placing an excessive burden on one of the

iii) The parties may wish to limit those terms which might be renegotiated or revised if certain events occur or surrounding circumstances have been changed. For example, the price, method of payment or the length of performance may be the only contractual terms to be subjected to renegotiation and adaptation. A limitation may be imposed on the time for requesting renegotiation. For example, it may be agreed that such a request should be made not earlier than five years after the conclusion of the contract.

iv) The revision clause may require the parties to participate in negotiations in good faith to adapt the relevant terms of the contract. The contract may go further, imposing an obligation on the parties to reach an agreement as to those terms. When the contract requires the parties to renegotiate or even to reach an agreement, Australian courts may refuse to enforce such terms on the grounds of uncertainty.[72] Nevertheless, in cases where the contract provides a mechanism for settling the issues if a dispute arises, the courts may adapt the contract in accordance with the mechanism provided. One of these mechanisms is the intervention of a third party mediator to settle the issue.

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parties in the performance of its contractual obligations, that party shall be entitled to request a revision of the present contract.
Such request shall be made to the other party within a reasonable time from the moment the requesting party becomes aware of the event and of its effect on the economy of the contract. The request shall indicate the grounds for revision. Failing such communication, the interested party shall be barred from making any request under this clause.
2. The parties shall consult one another with a view to revising the contract on an equitable basis, in order to avoid excessive prejudice to either party.
3. Failing an agreement of the parties on the adaptation of the contract within a time limit of 90 days of the request (for revision), either party may refer the case to the ICC Standing Committee for the Regulation of Contractual Relations in order to obtain the appointment of a third person (or a college of three members) in accordance with the provisions of the Rules on the Regulation of Contractual Relations of the ICC. The third person shall carry out his mission in accordance with the said Rules. He shall decide on the parties' behalf whether there are grounds for revision, and if so, what revision should be made. His decision shall be binding on the parties and shall be deemed to be incorporated in the contract. Performance of the contract shall be continued during the revision procedure.

72 See Chapter 7, pages 290ff.

v) A procedure for renegotiation may be set up by the parties to be followed so that an agreement becomes more achievable. The parties should also provide a mechanism for settling any dispute arising out of disagreement as to adaptation. They may agree on a third person to intervene to provide a recommendation or make a decision. When a third party is to intervene, the ICC Adaptation Rules can be agreed on to facilitate the implementation of the parties' arrangement.[73] Although it is possible to agree on the ICC Adaptation Rules even after the conclusion of the contract,[74] the parties may prefer to refer to the Rules in their contract to avoid subsequent disagreement. It is for the parties to agree whether or not the recommendation made by the third party should be binding.[75]

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73 ICC, *Rules on the Regulation of Contractual Disputes* (Pub No 326, 1977).

74 Article 1.2 of the Rules provides:

> At any time during their contractual relations, the parties may ask for the appointment, in accordance with the Article set forth below, of such a third person, or of a board composed of three members, to fulfil the task which has been contractually assigned to such third person or board.

75 Article 11 of the Rules provides:

> 1. The third person may either formulate a recommendation or take a decision depending on the choice made by the parties.
> 2. When the third person makes a recommendation, the parties will consider it in good faith.
> 3. When the third person takes a decision, that decision is binding on the parties to the same extent as the contract in which it is deemed to be incorporated. The parties agree to give effect to such a decision as if it were the expression of their own will.

2. Build-Operate-Transfer (BOT)

Under a typical BOT arrangement, a private consortium enters into an agreement with a government to build an infrastructure project within the government's territory and to operate and manage the project for a period of time. The cost of construction will be reimbursed by the proceeds generated through operating the project. After that period the project will be transferred to the government without any compensation. The details of the deal are generally set out in a legally-binding concession contract between the consortium and the host government. This contract is a basic framework for the parties' obligations as to the financing, designing, constructing and operating of the project. Thus, at least two parties are involved in BOT projects: i) a private consortium which undertakes to build, operate and transfer the project; and ii) a government which grants the concession to the consortium to build a project and operate it for a period of time.

The BOT projects are generally used for large infrastructure plants which involve construction, supply of machinery and materials, maintaining the project, providing services, and exploiting the project over a number of years. As a result, a special project company should be set up to handle financing, constructing and operating the project. In some countries the project company must be set up in the host country and in accordance with the laws of the country.[76] The project company is often a consortium of various parties such as

76 In Vietnam, for example, a BOT company has to be established in accordance with the Law on Foreign Investment in Vietnam. State Committee for Cooperation & Investment (SCCI), "Guiding the Implementation of the Regulations on Investments in the Form of Build-Operate-Transfer Contracts" (February 28, 1994) No 333 UB/LXT, Article 2. Similarly, in Indonesia the private consortium must be an Indonesian limited liability company. Connors, "Infrastructure in Indonesia" (November 2, 1994) *Australian Business Asia* 7 at 7.

lenders, equity investors, contractors to construct or to operate the project, suppliers of machinery, technology or raw materials, and the purchasers of the resultant services or products of the project. Since the government will grant the concession to the consortium as a legal entity and not to individual members of the consortium, creating a sound relationship between various parties to the consortium is necessary for the smooth implementation of the project and its success.

The main elements of a BOT arrangement, which will be discussed below, are: i) the kind of supports and assistance provided by the host government; ii) financing the project; iii) constructing the project as agreed; iv) ensuring that sufficient revenue will flow from the project; and v) converting the revenue generated to hard currency.

2.1. Government Support

The key reason underlying the use of BOTs is that the host government wants to increase the role of the private sector in economic development and to mobilise foreign resources for its own infrastructure projects. The responsibility of obtaining finance, designing, constructing and operating the project is therefore vested in the consortium. The consortium, however, is not able to advance the project without the cooperation and support of the host government. That is because infrastructure projects are generally connected with the government domain. The support of the host government is in particular essential because: i) the concession is given by the government; ii) the fixed assets belong to the government; iii) the pricing of the resultant goods or services is generally under government control; iv) the sole purchaser of the resultant services or products of the project may be the government; v) the convertibility of the revenue to hard currency depends on government policy and arrangements; and vi) the government may nationalise the project at some stage.[77] For these reasons, the success of a BOT project is greatly depends on the cooperation and support of the host government.

One of the foremost supportive actions of the government is to create a stable political and legal environment for the smooth implementation of BOT projects. The host country should establish a legal basis for the protection of the BOT consortium in reference to acquisition of land, preferential tax and tariff rates, the convertibility of revenues to the hard currency, a fair compensation against nationalisation and the like. The consortium should be supported also against the subsequent changes in law and policy which will have adverse effects on the consortium. Establishing a proper legal environment may be achieved through enacting general regulations as to foreign investment, dispute settlement, foreign currency availability and fair compensation in the event of nationalisation. Furthermore, it may also be necessary to enact specific provisions for the purposes of BOT projects to facilitate the participation of the private sector in BOT infrastructure projects.[78]

The main concern of a consortium, including financial institutions involved, is satisfaction that the project is economically viable and that sufficient revenue will be generated to cover the money invested and a reasonable profit for the consortium. Moreover, the money

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77 In a standard BOT contract published by the State Committee for Cooperation & Investment of Vietnam, the duties of the government have been stated in Article 3 as follows:

> Article 3: Obligations of Party A [the Government of Vietnam]
>
> 3.1 Create, in part of the host country, all necessary conditions for Party B [the consortium] and the BOT Company to enable them to fulfil their commitments stipulated in this Contract.
>
> 3.2 Take the responsibility in clearing the construction site, at the expense of Party B, in order to meet the requirement of construction according to schedule as agreed upon.
>
> 3.3 Assist the BOT Company in recruiting local staff to take part in the building and operating of the Project.
>
> 3.4 Ensure the Vietnamese Businesses to sign contracts to buy products provided by the BOT Company in the whole duration of the Contract in accordance to the terms and provisions of this Contract.

78 UNCITRAL, *Yearbook* vol XXVI (UN, New York, 1995) at 212.

invested in BOT projects is generally to be paid off after the start-up of the project and through revenues generated by the exploitation of the project. Thus, the consortium should ensure that: i) sufficient finance will be available for the project; ii) the project will be constructed as agreed; iii) the revenues will be sufficient to cover the loan and other costs; and iv) the revenue will be convertible to hard currency.

2.2. Financing the Project

Financing the project is one of the key issues to be managed by the consortium. The consortium usually finances the project by borrowing money from financial institutions or raising equity.[79] The main source of finance is generally foreign financial institutions or individual investors. Using local sources to finance part of the project is advantageous because it reduces the foreign exchange risks and the risk of local currency devaluation. Moreover, if no local bank is involved, foreign banks may assume that something is wrong with the project.[80] BOT projects are usually financed by means of limited or non-resource financing to which the lender has no access beyond the assets of the project. In other words, the government provides no guarantee as to the money invested in BOT projects. Thus, the allocation of risks to different parties involved is the key element of structuring the financing of a BOT project.[81] The consortium is responsible for allocating risks to various parties involved.

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79 Scriven, "A Banking Perspective on Construction Risks in BOT Schemes" (1994) *The International Construction L Rev* 313 at 314.

80 Norton, "BOT: Cash and Carry Project Finance" (September 1989) *Trade Finance & Banker International* 35 at 37.

81 Tiong, "BOT Projects: Risks and Securities" (1990) 8 *Construction Management and Economics* 315 at 317.

Since the completion of the project is essential for generating proceeds, the consortium in general and the lenders in particular are keen to ensure that the money is sufficient for the project, or, if it is not sufficient, some other sources are available. In lump-sum construction contracts, where the contractor is supposed to bear the risk of price increase, extra costs may be incurred as a result of design changes, force majeure, political instability, and unanticipated events.[82] In other pricing systems, such as *unit pricing* or *cost plus a fee*, where the extra costs are to be borne by the consortium, the costs may go beyond the expectation of the parties for one reason or another. The consortium may need to ascertain the possibility of further borrowing or raising more equities. To compensate for these costs, the consortium may wish to increase the price of the resultant services or to extend the length of the operation accordingly.

Where these additional costs incurred as a result of changes in a host country's law in terms of tax, tariffs, or environmental, health, safety and other construction standards, the consortium should seek to shift these costs to the host government. More generally, the concession contract may provide that any extra costs incurred as a result of subsequent legal or administrative changes must be borne by the government. Alternatively, the contract may provide that the consortium will run the project for a longer period of time if the costs exceed a limit or if they are caused by the government.[83]

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82 Stein, "Build-Operate-Transfer (BOT) - a Re-Evaluation" (1994) *The International Construction L Rev* 101 at 106.

83 Scriven, "A Banking Perspective on Construction Risks in BOT Schemes" (1994) *The International Construction L Rev* 313 at 316.

2.3. Construction of the Project as Agreed

BOT projects are similar to buy-backs to the extent that a project needs to be constructed by a party.[84] All issues discussed in buy-back in reference to construction, supply of equipment and technology transfer are similarly applicable to BOT projects. The construction of the project in accordance with the specifications and within the time-frame agreed on is significant in BOT projects. Any change in the specification of the project may result in extra costs, delay in completion or reduction in proceeds which may adversely affect the consortium. The delay in completion is another issue which the parties need to deal with appropriately.[85] Since the main reasons for a delay in completion are related to the nature of these projects which are tied to the public sector, such as roads, bridges, tunnels, pipelines, power stations and water supply facilities,[86] the contract should bind the government to support the project, for example, by coordinating among different government agencies connected to the projects or providing the raw materials needed for the construction. Alternatively, the parties may manage the problem of a delay by dividing the project into different phases, each one of which has to be finished within a schedule. In these cases, the investment for the subsequent phase may be based on the completion of the previous phase to ensure the viability of the project.

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84 At times BOT has been categorised as a variant of buy-back. See Brown & Franklin, *Countertrade Paying in Goods and Services* (Longman, London, 1994) at 25.

85 Nicklisch, "The BOT Model - the Contractor's Role as Builder - Contract Structure, Risk Allocation and Risk Management" (1992) *The International Construction L Rev* 425 at 429.

86 Stein, "Build-Operate-Transfer (BOT) - a Re-Evaluation" (1994) *The International Construction L Rev* 101 at 105.

2.4. Sufficiency of Revenue

Another key issue for BOT projects is the sufficiency of the revenue generated by the operation to cover the principal, interest, maintaining costs and profits for the consortium. The amount of revenue depends on the operation time and the price of resultant services. Two problems are significant in the amount of revenue returned to the consortium.

First, because BOT projects are generally government projects vested in the public sector, the prices are often under government control and hence beyond market forces. In some countries such intervention is obligatory for political or ideological reasons. For example, governments often subsidise the basic services like water, electricity and use of roads. These are typical BOT projects. To deal with this problem, a guarantee may be taken from the government to allow monopoly services to be sold at a price sufficient to repay the loan plus a reasonable profit for the equity holders. At times, a government agency agrees to purchase the resultant services during a period of time with a price formula which creates sufficient proceeds for the consortium. The off-take contract may be based on a take-or-pay mechanism whereby the government agency undertakes to pay a stipulated minimum sum for the resultant goods or services, irrespective of whether or not it takes them.[87] If the relevant services are to subsidised to the public, the government should pay the difference to the consortium.

The second problem is a reduction in revenue due to a rise in operating costs, or a fall in traffic flow and consumption. One option to deal with cost increases is to enter into long-term contracts for the supply of raw materials at a fixed price. Another option is to

87 Wood, *Law and Practice of International Finance*, (Sweet & Maxwell, London, 1989) at 317.

incorporate a price formula into the concession contract for the resultant goods or services so as to adjust the price in accordance with the rise in operation costs to ensure a sufficient cash flow to the consortium. Alternatively, the government may guarantee a minimum return to the consortium if the proceeds run under a limit.

2.5. The Convertibility of the Revenue to Hard Currency

In international BOT projects the loans and investment are often made in hard currency, while the revenue of the project is generated in local currency which needs to be sent out of the country in some form of hard currency. The local currency may not be convertible to hard currency in the world market. Even if its convertibility is guaranteed, the risk of local currency devaluation may be high, especially when the local currency is not traded outside the country to hedge against the devaluation risk. To mitigate these risks certain steps may be taken.

First, the loans and investment may be made in the local currency. In that case, its devaluation and convertibility is not a problem, because the payment is to be made in the currency of the loan and investment. If it is necessary to have some hard currency to import certain materials or machinery, the consortium may agree with the government to convert a portion of the local currency sufficient to import those necessities from outside.

Second, if the project has been financed in hard currency, the local currency generated from the BOT operation can be used for purchasing local products to export. By selling the products on the world market, the consortium can earn hard currency to repay the loans and dividends. Alternatively, the local currency can be used for investing in a new BOT project or be converted to the hard currency through debt-equity swaps.[88]

Third, if the convertibility of the local currency is not a problem but its devaluation is, an escalation clause may be incorporated into the contract according to which the price of the resultant goods and services is to be adjusted. Alternatively, the government may guarantee the difference if the exchange rate is dropped by more than a specific percentage. For example, in the North-South Expressway project the Malaysian Government guaranteed to pay the shortfall if the exchange rate were to drop by more than 15 percent.[89]

Fourth, the government may be requested to ensure that the proceeds will be freely and promptly convertible into a hard currency agreed by the parties. For example, Article 2.2 of the BOT guidance published by the State Committee for Cooperation & Investment (SCCI) of Vietnam provides: "The government guarantees the conversion of VND[90] received by the BOT into foreign currency to pay for the loans and other expenditures and remittances which have to be transferred abroad."[91] A local escrow account may be set up into which all proceeds are deposited in the local currency. From this account, the local investors receive their part in the local currency and the rest is converted to the hard currency and then deposited into an offshore escrow account established with the cooperation of the government.[92] The funds put into the offshore escrow account are allocated to the various foreign investors and lenders in accordance with their contracts.[93] The government may go

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88 See Chapter 1, pages 46-49.

89 Tiong, "BOT Projects: Risks and Securities" (1990) 8 *Construction Management and Economics* 315 at 323.

90 VND stands for Viet Nam Dong, the currency of Vietnam.

91 SCCI, "Circular Guidelines on Investment Regulation in Build-Operate-Transfer (BOT) Contracts" Doc VBR 09/94.

92 Stein, "Construction Financing and BOT Projects" (April 1995) *International Business Lawyer* 173 at 176.

93 For more information as to the escrow account see Chapter 8, pages 334-345.

further, fixing an exchange rate for converting the local currency to the hard currency to protect the consortium against the risk of local currency devaluation.

Fifth, the World Bank may provide a guarantee as to the convertibility of the local currency or as to a minimum return.[94] Such a guarantee may be provided as an aid package to the host country for development of an infrastructure project. The World Bank may agree to take the revenues in the local currency and pay the consortium in hard currency. The local currency may subsequently be invested in the host country for other projects. In the Hab River project in Pakistan, for example, the World Bank guaranteed the convertibility of the local currency, Pakistani Rupees, to the lenders.[95]

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94 Stein, "Build-Operate-Transfer (BOT) - a Re-Evaluation" (1994) *The International Construction L Rev* 101 at 110.

95 As above.

Conclusion

In this chapter the key elements of buy-back arrangements and BOT projects have been discussed. These two forms of countertrade involve the supply of materials, equipment and technology in order to set up a plant. In buy-back arrangements, the supplier is obliged to purchase back a portion of the goods produced in the project. By contrast, in BOT projects, the supplier exploits the project for a while in exchange for the price of the project. In both arrangements, the supplier of equipment and technology has a keen interest in the success of the project and the quality of the resultant output. This element puts a greater responsibility upon the supplier as compared to ordinary exporters who sell similar equipment and technology. The cooperation of the parties is, therefore, vital not only in planning and drafting the contracts but also in implementing them. On the one hand, these contracts are of a complex and long-term nature which require drafting as precisely as possible with appropriate mechanisms for unsettled issues or for those difficulties which may arise over the life of the arrangement. On the other hand, the reliance on contractual terms or the resort to litigation may not always be beneficial in these arrangements. These arrangements are usually concluded in an optimistic environment in which the parties expect long-term benefits through manual understanding and cooperation. The continuity of such an environment is essential for the success of these long-term and complex arrangements.

CHAPTER 10

International Economic Law and Countertrade

Introduction

In every country there are various rules regulating and controlling economic activities. These rules vary from country to country and are enacted to achieve social and economic objectives in light of political and ideological interests. An economic activity may be a purely internal matter with no foreign element involved or may connect with more than one country. Economic activities which relate to several countries may be regulated and controlled by more than one set of national laws. International countertrade as a cross-border economic activity is affected at least by the laws of the exporting and counter-exporting countries.

National governmental regulations are imposed either generally on every international economic activity or specifically on countertrade. The motives underlying these rules include raising revenue, preserving the health, safety and welfare of citizens, facilitating trade practices, maintaining a healthy environment for conducting business, supporting the national currency, providing protection to domestic industries, and achieving political or social objectives. In particular, customs legislation and export-import rules which control and regulate the movement of goods, services and capital across borders have a crucial impact on any international transaction, including countertrade. In addition to the regulations which apply to every international economic activity, certain rules may be in force specifically to control and regulate countertrade practices. It is beyond the scope of this research to examine all the national rules which may have an impact on countertrade practices because they are varied and generally not exclusive to countertrade.

Nevertheless, there is a set of rules, known as international economic law, which regulates and controls the behaviour of States in managing or implementing their trade policies.[1] This body of law, which regulates international economic activities, is composed of bilateral treaties, multilateral treaties and constitutions of international economic institutions.[2] International economic law applies directly to governments, constraining their intervention in economic exchanges. The intervention of governments in economic activities is generally achieved in two ways. First, governments control and regulate economic activities through legislation. Second, governments influence economic activities through their unique powers of spending, borrowing, raising tax, and conducting commercial activities through State-owned enterprises. The purpose of international economic law is to regulate and control the intervention and influence of governments in international economic activities. Although the persons acting as individuals or business units are not directly subject to the rules, the rules have a profound indirect impact on them.

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1 For different definitions of international economic law see: Fox, "The Definition and Sources of International Economic Law" in Fox (ed), *International Economic Law and Developing States* (The British Institute of International and Comparative Law, London, 1992) at 12-15.

2 Some of these institutions are worldwide, such as the World Trade Organisation (WTO), the International Monetary Fund (IMF), and the Organisation for Economic Co-operation. (OECD). Some of them are regional such as the European Economic Community (EEC).

Countertrade as an international economic activity may be used by countries to achieve economic or political objectives, such as extending the marketing network, directing foreign investment and technology into the country, ensuring the supply of essential imports, correcting a trade deficit, or supporting a friendly country. To implement these policies, a State may use its legislative power to encourage or mandate countertrade directly or indirectly. Alternatively, the State may use its mass economic capacity to induce foreign trading partners to engage in countertrade through its State-owned corporations and government agencies.[3]

In Australia, for example, certain government purchasing needs to be carried out through offset programs in both military and civil sectors. Offset programs have been mandated by the Australian Government since 1970.[4] Similarly, the Agreement on Economic and Technical Co-operation in the Iron and Steel Industry between Australia and China calls on the parties to encourage commercial negotiations leading to countertrade practices. Article 4 of this Agreement provides:

> In facilitating and promoting economic and technical co-operation the two Governments shall encourage commercial negotiations leading to contracts, joint ventures, barter, compensation trade in products and other arrangements between relevant organisations and enterprises.[5]

Australia, like other sovereign States[6], is eligible to use legislation or its economic strength as a means of achieving its economic policies by encouraging or mandating countertrade. However, the ability of a State to intervene in international trade and economic activities is

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3 For a detail discussion of the different ways by which a State encourages or mandates countertrade See Chapter 1, pages 49-52.

4 See generally, Bureau of Industry Economics, *Monitoring of the Offsets Program* (Australian Government Publishing Service, Canberra, 1987).

5 Agreement on Economic and Technical Co-operation in the Iron and Steel Industry between the Government of Australia and the Government of the People's Republic of China. *Australian Treaty Series* (No 28, 1984).

6 For a discussion about the basic economic rights of States see Seidl-Hohenveldern, *International Economic Law* (Kluwer, Dordrecht, the Netherlands, 1992) at 102-129.

limited under international economic law. The WTO, IMF and OECD, as international organisations of which Australia is a member, have a crucial impact on international trade activities worldwide. These organisations impose certain obligations upon their members in relation to economic, finance and trade activities, limiting their authority over the running of the economy. The purpose of this chapter is to examine whether members of these organisation violate their obligations if they engage in or mandate countertrade.

1. The WTO and Countertrade

In 1947 a multilateral treaty known as the General Agreements on Tariffs and Trade (GATT) was signed to promote trade between the contracting parties on a non-discriminatory basis. It was contemplated that the GATT would operate under the proposed International Trade Organisation (ITO). Since the ITO never came into existence, the GATT sought to fill the gap by developing its own institutional elements.[7] As a result, the GATT has become a multilateral treaty between the contracting countries and a Geneva-based organisation to administer the multilateral treaty. The World Trade Organisation (WTO) was established on 1 January 1995 as a result of eight years of multilateral trade negotiations known as the Uruguay Round to succeed the GATT.[8] The institutional and procedural functions of the GATT were formally transferred to the WTO. The GATT 1947, as rectified, amended or modified before the date at which the WTO came into existence, has been incorporated into the GATT 1994 which is annexed to the WTO Agreement. Thus, the principles of the GATT 1947 and the GATT 1994 are to a great extent the same.

The Charter of the WTO, framing the institutional and procedural structures of the WTO, and its Annexes 1, 2 and 3, referred to as *Multilateral Trade Agreements*, are integral parts of the WTO Agreement, binding on all members. Annex 4, referred to as *Plurilateral Trade Agreements*, however, is binding only on those members accepting them.[9] The

7 Jackson & Davey, *Legal Problems of International Economic Relations* (West Publishing Co, St Paul Minn, 2nd ed 1986) at 293ff.

8 Under the auspices of GATT, a new round of multilateral negotiations started in Uruguay in September 1986 which continued until April 15, 1994.

9 Article II of the Agreement Establishing the World Trade Organisation.

significant components of the Multilateral Trade Agreements are the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), and the Understanding on Rules and Procedures Governing the Settlement of Disputes.

The WTO Agreement is a government-to-government treaty by which the signatory States give up parts of their sovereignty, subjecting themselves to the rules and decisions of the WTO. Governments generally implement their commercial policy through enacting rules or involving in economic activities as entrepreneurs. The WTO regulates and controls government intervention in economic activities in respect of enacting rules or conducting state trading enterprises. The WTO does not directly impose any obligation on the economic behaviour of individuals or private trading corporations. As a result, the issue of compatibility or non-compatibility of the WTO Agreement with countertrade is confined to cases where States members through legislation or state trading enterprises encourage, demand or mandate countertrade.

These countertrade policies may be viewed as inconsistent with the WTO on three bases: i) they are against the spirit of the WTO which aims at liberalising international trade; ii) they violate certain provisions of the WTO Agreement; and iii) they violate the Agreement on Government Procurement, binding only those WTO members who accept it.[10]

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10 The application of WTO rules to countertrade practices is a matter of interpretation. Article 31 of the Vienna Convention on the Law of Treaty has set out the general rule of interpretation as follows:

> 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
> 2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes.

A copy of the Convention can be found in *Australian Treaty Series* (No 2, 1974).
With respect to the application of the GATT to a trade practice, Jackson said:

1.1. Countertrade and the Spirit of the WTO

Encouragement of or demand for countertrade by governments could be perceived as a trade policy against the purposes and spirit of the WTO Agreement. The objectives of the WTO Agreement are well stated in the preamble to the WTO Charter. It provides that the Parties recognise that:

> their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development.[11]

These objectives are to be met by "entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations".[12] Although the WTO Agreement aims at creating an environment for the State members to achieve a balance in their exports and imports globally but not vis-à-vis individual countries, countertrade aims at achieving a balance in the country's export and imports with respect to individual trading partners. When a countertrade commitment is demanded for any export to the country, the country may restrict the export of other trading partners which do not

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> The starting point of any interpretation or application is of course the words of the treaty itself. Even at this beginning point, however, it must be recognised that certain clauses of GATT do not reflect the currently accepted practise. ... Furthermore, even though appropriate clauses in GATT are discovered to be relevant to a particular situation, the extent to which a particular clause has been accepted by nations, or applies to their particular practices in the face of the large number of exceptions possible, is a complex question which must be approached with considerable caution.

Jackson, *World Trade and the Law of GATT* (Bobbs-Merrill Co, the USA, 1969) at 19-20.

11 WTO, *The Results of the Uruguay Round of Multilateral Trade Negotiations: the Legal Texts*, (WTO, Geneva, 1995) at 6.

12 The Preamble to the WTO Charter.

undertake that commitment. If the country does not want to restrict other trading partners' access to its market, certain preferential treatment may be provided to those committed to a countertrade undertaking. Thus, taking such measures to link imports into the country to the undertaking of countertrade obligations is based on bilateral trade preferences which the WTO aims to eliminate.[13]

This anxiety as to the proliferation of countertrade practices and their impact on free trade and multilateralism has been clearly shown in a report prepared in 1984 by the GATT Consultative Group of Eighteen. The report said:

> A study had been prepared by the secretariat, at the request of members, on the economics of countertrade and the possible relevance to it of GATT rules. There was general agreement that countertrade or barter had proliferated in recent years, and some members deplored this as a movement towards bilateralism and towards primitive, expensive and discriminatory business methods. The point was made that countertrade required or mandated by governments was incompatible with the obligation of all contracting parties to maintain a multilateral system based on GATT rules.[14]

This report shows that the extensive use of countertrade is a return to bilateralism which is against the objectives of the WTO, based on multilateralism and non-discriminatory trade practices.

In many cases, however, countertrade polices are implemented by some countries in response to financial difficulties, an export-import deficit or existence of non-tariff barriers

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13 Arthur Dunkel, the then Director-General of the GATT, warning against bilateralism and sectoralism in trade policy said:

> A foreign trade policy has to consider national trade needs globally; as sectoral arrangements proliferate, coherent policy-making becomes impossible, and economic efficiency is lost at every stage. ... [I]t was 'in the national interest of every trading nation to abide by the rules, which were accepted as valid for good times and bad, and to frame their internal polices accordingly. Those who believe in the open trading system must recognise and accept the need to correct those rigidities in their economic and social systems which obstruct the process of continuing adjustment on which economic growth depends.'

GATT, 12 *Focus* (March 1982) at 4.

14 GATT, *Basic Instruments and Selected Documents,* 31 supplement, at 56; Doc L/5721.

in developed countries' markets. The GATT report of the Consultative Group of Eighteen summarised the argument of these countries in adopting countertrade policies:

> On the other hand, some members pointed out that countertrade might be unavoidable where there was no other means of financing transactions and could therefore be expected to proliferate in a situation of extreme payments imbalances. Protectionist policies might also make recourse to countertrade necessary.[15]

Moreover, countertrade is often mandated by developing countries which enjoy more favourable treatment under the WTO. The vulnerable position of these countries is acknowledged in the preamble to the WTO Charter. Accordingly, the State members recognise that:

> there is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development.[16]

Countertrade policies adopted by developing countries can be perceived rightly to be in accord with 'the needs of their economic development'. Thus, it is difficult to show that a countertrade policy adopted by a developing country is against the spirit of the WTO which aims, inter alia, at securing a share for these countries in international trade by permitting special treatment in their interests. However, even if mandating countertrade is viewed as being against the objectives and spirit of the WTO, it is difficult to establish a legal basis for WTO violation because these objective are goals rather than legally binding.[17] It is therefore necessary to examine whether adopting countertrade policies violates any particular WTO rules.

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15 GATT, *Basic Instruments and Selected Documents,* 31 supplement, at 56; Doc L/5721.

16 As above.

17 Jackson, *World Trade and the Law of GATT* (Bobbs-Merrill Co, the USA, 1969) at 26.

1.2. Countertrade and the WTO Rules

Apart from the argument that mandating countertrade is against the spirit of the WTO Agreement, there are certain provisions of the Agreement likely to be violated if countertrade is encouraged or mandated by a State member. The WTO rules which might be violated due to mandating or encouraging countertrade practices are the Most-Favoured-Nations (MFN) clause (GATT Article I), the Elimination of Quantitative Restrictions (GATT Article XI), the National Treatment principle (GATT Article III), State Trading Enterprises (GATT Article XVII), and the Agreement on Trade-Related Investment Measures (Annex) which will be discussed below.

1.2.1. Most-Favoured-Nation and Countertrade

Article I, as the key provision of GATT, imposes an obligation on the WTO members to grant every other member as favourable treatment as it grants any other member with respect to imports and exports of similar goods. As a result, "any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties".[18] With respect to trade in services, this obligation is echoed in Article II of the General Agreement on Trade in Services (GATS).[19] A government may provide some preferential treatment to

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18 GATT Article I.

19 GATS Article II:1 provides:

> With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less than that it accords to like services and service suppliers of any other country.

those firms undertaking a countertrade commitment to encourage them to get involved in countertrade transactions. If the government grants such preferential treatment to those trading partners importing goods or services under countertrade schemes, the government violates its obligation to grant no less favourable treatment to those importing outside countertrade schemes.[20]

In 1973, the GATT secretariat was asked for a legal opinion on whether the tariff exemptions or reductions granted to goods imported under a co-operation contract is inconsistent with Article I of the GATT. The secretariat pointed out that "the prerequisite of having a co-operation contract in order to benefit from certain tariff treatment appeared to imply conditional most-favoured-nation treatment and would, therefore, not appear to be compatible with the General Agreement" on Tariffs and Trade (GATT).[21] It should be noted that this legal opinion is not binding because, as the secretariat emphasised, the issue of interpretation was a matter for the CONTRACTING PARTIES and not for the secretariat.[22]

The problem with this argument is that the most-favoured-nation clause requires members not to discriminate between other members, by granting an advantage, favour, privilege or immunity to one member but not to another in respect of the same products or services. When a country provides some preferential treatment to companies undertaking countertrade commitments, as is often the case in mandating or encouraging countertrade,

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20 Roessler, "Countertrade and the GATT Legal System" (1985) 19 *Journal of World Trade Law* 604 at 605.

21 GATT, *Basic Instruments and Selected Documents,* 20 supplement, at 36; Doc L/3889, adopted on 30 July 1973.

22 As above. Under Article IX:2 of the WTO Agreement, the Ministerial Conference and the General Council have exclusive authority to adopt interpretations of this Agreement and of the Multilateral Trade Agreements.

the advantages are equally offered, without any discrimination, to foreign companies ready to undertake a counter-export, irrespective of their nationalities.[23]

By contrast, if such preferential treatment is given only to certain members then violation of the most-favoured-nation clause would have occurred. For example, bilateral arrangements, under which two governments agree to exchange up to a fixed amount of goods or services over a period of time, seem inconsistent with the most-favoured nation principle. That is because bilateral arrangements grant privileges and finance only to the goods or services imported from the other party to the arrangement. This discriminatory behaviour may be justified on the account of Article XII of the GATT which permits the members to "safeguard its external financial position and to protect its balance of payments" by imposing restrictions on imports. As a result, if bilateral arrangements are entered into as a balance-of-payment measure, they are in accord with the MFN exception prescribed in Article XII of the GATT.

1.2.2. Quantitative Restrictions and Countertrade

In some cases, a government makes the issuance of import licences for certain goods or services conditional upon a countertrade commitment.[24] Thus, an application for import licences will be processed if the importer undertakes a countertrade commitment. Other applications will be rejected for not including a countertrade commitment in their offers. When import licences are to be granted on such a condition, the import to the country is

23 Gadbaw, "The Implications of Countertrade under the General Agreement on Tariffs and Trade" (1983) 5 *J Comparative Bus & Capital Market L* 355 at 359.

24 See Chapter 2, page 70.

restricted in a way different from those subscribed under Article XI of the GATT. Article XI provides:

> No prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licences or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation or sale for export of any product destined for the territory of any other contracting party.

Although the title of this Article is *General Elimination of Quantitative Restrictions* implying that Article XI is only concerned with quantitative restrictions, the GATT Panel on Trade in Semi-Conductors pointed out that "this wording was comprehensive; it applied to all measures instituted or maintained by a contracting party prohibiting or restricting the importation, exportation or sale for export of products other than measures that take the form of duties, taxes or other charges."[25] Thus, restricting imports to those undertaking a countertrade commitment violates the Article XI, even though this restriction does not operate like a quota.[26]

Furthermore, an Agreement on Import Licensing Procedures has been incorporated into the WTO rules to strengthen the GATT general rules with respect to import licensing.[27] The Agreement is part of the Annex I which binds all WTO members. In accordance with the Agreement, licensing is divided into automatic[28] and non-automatic procedures.[29] If non-automatic licensing is selected by a government, licensing "shall not have trade-restrictive or

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25 GATT, *Japan-Trade in Semi-Conductors* (1989) 35th Supp, Basic Instruments and Selected Documents (BISD) at 153.

26 Zeller argued that since countertrade requirements do not constitute quantitative restrictions, they fall outside the scope of Article XI which prohibits only quantitative restrictions. Zeller, "Countertrade, the GATT, and the Theory of the Second Best" (1988) 11 *Hastings International & Comparative L Rev* 247 at 268.

27 The Agreement is basically similar to the code on licensing negotiated in the Tokyo Round. Hoekman & Kostecki, *The Political Economy of the World Trading System* (Oxford University Press, Oxford, 1995) at 98.

28 "Automatic import licensing is defined as import licensing where approval of the application is granted in all cases". Article 2(1) of the Agreement on Import Licensing Procedures.

29 Article 2 & 3 of the Agreement on Import Licensing Procedures.

-distortive effects on import additional to those caused by the imposition of the restriction."[30] The issuance of import licensing conditional on undertaking a countertrade commitment restricts those not undertaking such a commitment. This restriction violates Article XI which does not permit the State members to restrict trade through measures other than duties, taxes or charges.[31]

Since the countries mandating countertrade often suffer from a balance-of-payment difficulty or belong to the less developed economies, they may take certain measures to safeguard their external financial position or to implement their programs and policies of economic development. Under prescription of Articles XII and XVIII(b), a country may restrict imports on the grounds of balance-of-payment difficulties. Article XII permits members to "restrict the quantity or value of merchandise permitted to be imported" if certain conditions are satisfied.[32] The Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994 obliges the members "to announce publicly, as soon as possible, time-schedules for the removal of restrictive import measures taken for balance-of-payment purpose".[33] A country facing problems in its external financial problems may mandate that any foreign company importing certain goods or services must meet a counter-export demand at least not to worsen its balance-of-payment equilibrium. Since Paragraph 2 of the Understanding requires the members "to give preference to those measures which have the least disruptive effect on trade",[34] linking

30 Article 3(2) of the Agreement on Import Licensing Procedures.
31 Verdun, "Are Governmentally Imposed Countertrade Requirements Violations of the GATT?" (1985) 11 *Yale J International L* 191 at 213.
32 GATT Article XII(1).
33 Paragraph 1 of the Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994.
34 Paragraph 2 of the Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994.

imports of certain products to counter-exports is less disruptive compared to a total ban on imports of those products or an arbitrary import restriction.

Similarly, under Article XVIII the less developed countries may take protective or other measures to "implement programs and polices of economic development designed to raise the general standard of living of their people".[35] A less developed country may view countertrade as a means to implement its economic policy.[36] The measures which may be taken by these countries are broad enough to cover cases where a countertrade requirement is imposed as the condition for import of certain products. Mandating or encouraging countertrade may be perceived by a country as a way to raise the general standard of living of its people which is prescribed by Article XVIII.[37] As an unpublished report by the GATT secretariat pointed out, "the rules of the General Agreement and of the codes relating to the use of restrictive import measures and export subsidies appear to be sufficiently broad to cover also those cases in which protection or export subsidisation results from a requirement or inducement to engage in countertrade."[38] In sum, although linking imports to the country to counter-exports violates Article XI, under Articles II, XVIII(b) and XVIII a country may adopt countertrade polices if such a policy is essential for its balance-of-payment position or if it enjoys a less developed status.

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35 Article XVIII(2).
36 OECD, *Countertrade: Developing Country Practices* (OECD, Paris, 1985) at 18.
37 See Chapter 2, page 54.
38 Quoted from Parry, "GATT Weighs the Evidence of Discrimination in the Growing Practice of Global Bartering" (September 21, 1984) *The American Banker* at 39.

1.2.3. National Treatment and Countertrade

The national treatment principle, set out in Article III of the GATT, provides that the goods imported should be treated the same as local goods in respect of taxes, regulation and requirement. Article III(4) provides that the products imported "shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use". This obligation will be violated if a countertrade policy requires exporting parties to buy certain components of a project from products of national origin. Through this policy, the domestic products are accorded treatment more favourable than that accorded to similar products imported. For example, if under a buy-back or offset program, a car exporting company is required to buy certain components of the cars from domestic producers, this requirement results in giving less favourable treatment to the components imported than to like components of national origin.

In 1982, a GATT Panel was faced with the question whether imposing a requirement on foreign investors to purchase goods of national origin violates the principle of national treatment.[39] The Panel found that an undertaking to purchase goods of national origin "excludes the possibility of purchasing available imported products so that the latter are clearly treated less favourably than domestic products and that such requirements are therefore not consistent with Article III:4."[40] Although this case was related to local content requirements imposed on foreign investors, the finding equally applies to cases

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39 GATT, *Canada-Administration of the Foreign Investment Review Act* (1984) 30th Supp, Basic Instruments and Selected Documents (BISD) at 140.

40 At 159.

where such requirements are imposed on exporting firms under a countertrade policy. It is to be noted that most local purchase requirements are imposed in respect of government procurement which is expressly excluded from the national treatment obligations by virtue of Article III:8.[41] As a result, if a countertrade policy favours local producers against foreign producers, it will be inconsistent with the national treatment obligations set out in Article III, provided that the countertrade policy is not related to purchases for governmental purposes.

1.2.4. State Trading Enterprises and Countertrade

In many cases a countertrade policy is implemented not through legislation but rather through the economic power which a government has as a large consumer, producer or trader. The use of consumption strength for countertrade purposes will be discussed below under Government Procurement and Countertrade. Governments may implement a countertrade policy through state trading enterprises, directing them to deal with those foreign exporters which undertake a countertrade requirement.[42] As directed, these enterprises purchase from those firms which undertake full or partial counter-export deliveries, although they may claim that their decisions are made in accordance with market forces. As a result, in practice those foreign exporters which include a countertrade commitment in their offers would be preferred to those reluctant to do so.

To discuss whether implementing countertrade policies through state trading enterprises violates the WTO rules, it is necessary to define 'state trading enterprises' and the

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41 See below, pages 429ff.

42 Walsh, *Mandated Countertrade: Methods and Issues* (Staff Paper #16, National Center for Export-Import Studies, 1985) at 5.

obligations imposed on them. The GATT 1947 provided no explicit definition of 'state trading enterprises'.[43] It is necessary to determine how much governmental influence is required to make an enterprise a state trading enterprise. When a government owns, controls or grants an exclusive and special privilege to an enterprise, the enterprise is a state trading one.[44] In the Understanding on the Interpretation of Article XVII of the GATT 1994, the following definition has been adopted for state trading enterprises:

> Governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports.[45]

Since the state trading enterprises can influence the free movement of goods and services across the borders,[46] Article XVII of the GATT has put certain obligations on these enterprises. It requires that the state enterprise "shall, in its purchases or sales involving either import or exports, act in a manner consistent with the general principles of non-discriminatory treatment prescribed in this Agreement for governmental measures affecting imports or exports by private traders". The Understanding on the Interpretation of Article XVII requires the members to notify such enterprises to the Council for Trade in Goods for review by the Working Party in order to ensure the transparency of their activities.[47]

A GATT violation may be alleged on the grounds that a state enterprise which trades only with those undertaking a countertrade requirement acts in a manner inconsistent with the general principle of non-discriminatory treatment imposed on these enterprises by virtue of

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43 Kostecki, "State Trading in Industrialised and Developing Countries" (1978) 12 *J World Trade L* 187 at 188.

44 Ianni, "The International Treatment of State Trading" (1982) 16 *J World Trade L* 480 at 481-482.

45 WTO, *The Results of the Uruguay Round of Multilateral Trade Negotiations: the Legal Texts*, (WTO, Geneva, 1995) at 25.

46 Kostecki, *East-West Trade and the GATT System* (St Martin's Press, New York, 1979) at 45.

47 Paragraph 1 of the Understanding on the Interpretation of Article XVII of the GATT 1994.

Article XVII.[48] It is, however, difficult to ascertain that a countertrade policy dictated to a state trading enterprises per se constitutes a GATT violation, considering the fact that the formation of state enterprises or governmental guidance of their management is not prohibited in the GATT.[49] Article XVII(b) requires the State members to ensure

> that such enterprises shall, having due regard to the other provisions of this Agreement, make any such purchases or sales solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation and other conditions of purchase or sale, and shall afford the enterprises of the other contacting parties adequate opportunity, in accordance with customary business practice, to compete for participation in such purchases or sales.[50]

The ultimate requirement imposed on these enterprises is to trade solely in accordance with commercial considerations, affording the other members' enterprises adequate opportunity to compete for participation in deals. With such vague requirements, it is difficult to show that a state trading enterprise purchasing only from those foreign firms undertaking countertrade obligations discriminates against the others without commercial consideration. As a result, the GATT rules as to the state trading enterprises are not clear enough to restrict these enterprises from involvement in countertrade practices. In conclusion, although state enterprises are required to act in a manner consistent with the general principles of non-discriminatory treatment, it is difficult to prove that their countertrade requirements leads to discrimination without commercial consideration.

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48 Gadbaw, "The Implications of Countertrade Under the General Agreement on Tariffs and Trade" (1983) 5 *J Comparative Bus & Capital Market L* 345 at 361-362; Liebman, "GATT and Countertrade Requirements" (1984) 18 *J World Trade L* 252 at 2256-257.

49 McGovern, *International Trade Regulation* (Globefield Press, Great Britain, 1995) at 6.11-1.

50 Article XVII (b) of the GATT 1994.

1.2.5. Trade-Related Investment Measures and Countertrade

The Agreement on Trade-Related Investment Measures (TRIM) has been adopted as a result of the Uruguay Round "to promote the expansion and progressive liberalisation of world trade and to facilitate investment across international frontiers so as to increase the economic growth of all trading partners, particularly developing country Members, while ensuring free competition".[51] In an illustrative list annexed to the Agreement, the following measures are, inter alia, considered inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994: i) a requirement that investors are to source a specified minimum portion of their purchases from local sources; and ii) a requirement that products imported by investors are to be limited to the volume or value of local products that they export. These measures are inconsistent with the requirement of national treatment if they are mandatory or enforceable under domestic law or under administrative rulings, or if compliance with the measures is necessary to obtain an advantage.[52]

The Agreement emphasises the national treatment obligations and quantitative restrictions, set out in Articles III and XI of the GATT, in respect of investment measures which cause trade-restrictive and distorting effects.[53] Under a countertrade policy, the foreign investors may be required to export local products up to a proportion of the value of the products imported for the project, or to purchase products of domestic origin to incorporate them

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51 The preamble to the Agreement on Trade-Related Investment Measures.

52 Paragraph 1 of the Annex to the Agreement on Trade-Related Investment Measures.

53 Article 1 of the Agreement on Trade-Related Investment Measures. Compare Article XVI of the General Agreement on Trade in Services (GATS) which prohibits "limitations on the participation of foreign capital terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment."

into the goods to be produced in the project.[54] Since this countertrade policy restricts the imports and exports or results in giving less favourable treatment to the similar products imported, it is inconsistent with Articles III and XI of the GATT. Nevertheless, Article 4 of the Agreement on Trade-Related Investment Measures permits developing countries to deviate temporarily from the obligations imposed by the Agreement. As a result, if a countertrade policy leads to the imposition of certain investment measures which causes trade-restrictive and distorting effects, the policy is inconsistent with the WTO rules, unless such actions have been taken temporarily by developing countries.

1.3. Government Procurement and Countertrade

A government may use its consumption strength to implement a social-employment policy or development strategy through demanding countertrade commitments as part of the contract negotiation. By way of legislation or just as an administrative decision, a government may negotiate large import contracts for government procurement only under countertrade schemes.[55] The use of countertrade in the form of offsets is widespread among both the developing and developed countries, particularly in the defence trade[56] and the aerospace industry.[57] Offset programs are used by governments to offset, at least partly, the heavy costs of government procurement, reducing their economic burden. The foreign bidders will be required either to use the local products or subcontractors in the

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54 The Illustrative List annexed to the Agreement on Trade-Related Investment Measures.

55 See Chapter 1, pages 49-52.

56 "Offsets in Defense Trade" (1996) 117 (9) *Business America* 155 at 155.

57 Golden, "The International Offset Phenomenon in the Aerospace Industry" in Korth (ed), *International Countertrade* (Quorum Books, New York, 1987) at 61.

procurement program or to undertake to counter-export some domestic unrelated products.[58]

Government procurement is excluded from the general principles of the WTO Agreement. Under the Article III:8(a) of the GATT, government procurement is excluded from the general obligation of national treatment requiring the members to treat the imported products the same as the national products.[59] Article XVII which deals with state trading enterprises also excludes those purchases made for immediate or ultimate consumption in governmental use.[60] The distinction between government procurement and other trade activities of state enterprises is also recognised in the Understanding on the Interpretation of Article XVII regarding the notification requirement imposed on the members as to activities of the state enterprises.[61] Similarly, the Article XIII of the General Agreement on Trade in Services (GATS) excludes government procurement from the obligations of Article II as to the most-favoured-nation treatment, Article XVI in regard to market access commitment, and Article XVII as to national treatment.[62] Article 1.4 of the Agreement on Technical

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58 For direct and indirect offset programs see Chapter 1, pages 31-33.

59 Article III:8(a) provides:

> The provisions of this Article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale.

60 Article XVII (2) provides:

> The provisions of paragraph 1 of this Article shall not apply to imports of products for immediate or ultimate consumption in governmental use and not otherwise for resale or use in the production of goods for sale. With respect to such imports, each contracting party shall accord to the trade of the other contracting parties fair and equitable treatment.

61 Paragraph 1 of the Understanding on the Interpretation of Article XVII of the GATT 1994 provides:

> This notification requirement does not apply to imports of products for immediate or ultimate consumption in governmental use or in use by an enterprise as specified above and not otherwise for resale or use in the production of goods for sale.

62 Article XIII (1) of GATS provides:

> Articles II, XVI and XVII shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of services purchased for governmental purposes and not with a view to commercial resale or with view to use in the supply of services for commercial sale.

Barriers to Trade also excludes government procurement from the provisions of the Agreement.[63]

In sum, the general WTO principles do not cover purchases made for governmental consumption. Consequently, a country is at liberty to require that every purchase for government consumption be made through a countertrade program. Since there is no regulation in the WTO general rules restricting a country from mandating countertrade for government procurement, offset programs required by a number of WTO members for the goods or services imported for government procurement purposes are not against their obligations under the WTO Agreement.[64]

In the Tokyo Round, for the first time, an Agreement on Government Procurement (Government Procurement Code) was adopted in respect of government purchases.[65] A reference to offset requirements was made in the Code. Article V:15(h) of the Code, as amended in 1988, pointed out:

> entities should normally refrain from awarding contracts on the condition that the supplier provide offset procurement opportunities or similar conditions. In the limited number of cases where such requisites are part of a contract, Parties concerned shall limit the offset to a reasonable proportion within the contract value and shall not favour suppliers from one Party over suppliers from any other Party. Licensing of technology should not normally be used as a condition of award but instances where it is required should be as infrequent as possible and suppliers from one Party shall not be favoured over suppliers from any other Party. In the limited number of cases where offset procurement opportunities or similar conditions are

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63 Article 1.4 provides:

> Purchasing specifications prepared by governmental bodies for production or consumption requirements of governmental bodies are not subject to the provisions of this Agreement but are addressed in the Agreement on Government Procurement, according to its coverage.

64 However, when state enterprises are involved in purchases for government procurement purposes, Article XVII:2 of the GATT requires the members to accord to the trade of the other members fair and equitable treatment.

65 Janik, "A U.S. Perspective on the GATT Agreement on Government Procurement" (1987) 20 *Geo Wash J International L & Economics* 491 at 491.

> required, these requirements shall be included in the notice of proposed procurement and tender documentation.[66]

This Article did not prohibit entirely the use of offset programs for government procurement. In limited cases, government entities may ask for offset obligations if they are part of the contract and their amount is reasonable compared to the value of the contract. As a result of the Uruguay Round, an Agreement on Government Procurement has replaced the Government Procurement Code. The Agreement, incorporated into the WTO documents as a WTO Plurilateral Trade Agreement, has a voluntary status binding only participating members. On 1 January 1996, the Agreement came into existence by membership of mostly developed countries.[67] So far, Australia has not joined the Agreement.

Article XVI of the Agreement prohibits the State members imposing, seeking or considering offsets "in the qualification and selection of suppliers, products or services, or in the evaluation of tenders and award of contracts".[68] In a footnote to the Article, offsets have widely been defined as: "measures used to encourage local development or improve the balance-of-payment accounts by means of domestic content, licensing or technology, investment requirements, counter-trade or similar requirements". In addition to the fact that such a broad definition makes its enforceability difficult, there is no clear distinction

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66 This Article has been replaced by Article XVI of the Agreement on Government Procurement, as a result of the Uruguay Round.

67 They include Canada, the European Union (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Luxembourg, Portugal, Spain, Sweden, and the United Kingdom), Hong Kong, Israel, Japan, Korea, Norway, Singapore, Sweden, Switzerland and the US. De Graaf & King, "Towards a More Global Government Procurement Market: The Expansion of the GATT Government Procurement Agreement in the Context of the Uruguay Round" (1995) 29(2) *International Lawyer* 435 at 435; Hird, "Government procurement" in Anderson (ed), *Strengthening the Global Trading System: From GATT to WTO* (Center for International Economic Studies, University of Adelaide, Adelaide, 1996) at 127.

68 Article XVI of the Agreement on Government Procurement.

between what are called offset requirements and project specifications.[69] Apart from such technical difficulties, the Article only binds the signatories of the Agreement with respect to those government entities included in the signatory's lists of entities to be covered by the Agreement, and so far as the value of the procurement contract is not less than that the amount specified in the signatory's annexes.[70] The telecommunications sector, defence-related equipment, aircraft and ships are among those products most commonly excluded by signatories from the coverage of the Agreement, though the use of offsets in these sectors is very common.[71]

Moreover, Article XVI:2 permits developing countries to negotiate, at the time of accession, conditions for the use of offsets, provided that such offset "requirements shall be used only for qualification to participate in the procurement processes and not as criteria for awarding contracts."[72] Israel has benefited from the developing country status by successfully negotiating the use of offsets by means of demanding foreign suppliers to subcontract a percentage of their procurement contracts to local companies.[73] As a result, although the Agreement restricts the signatories to imposing offset programs for government procurement, the exceptions and derogation prescribed by the Agreement put many cases of offsets outside the coverage of the Agreement. Even in cases where offset

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69 Dodds, "Offsets in Chinese Government Procurement: the Partially Open Door" (1995) 26 *Law & Policy in International Business* 1119 at 1139.

70 Article I of the Agreement on Government Procurement provides:

> 1. This Agreement applies to any law, regulation, procedure or practice regarding any procurement by entities covered by this Agreement, as specified in Appendix I....
>
> 4. This Agreement applies to any procurement contract of a value of not less than the relevant threshold specified in Appendix I.

71 Johnsson, "Experience of Indirect-Offset Operations in the Swedish JAS 39 Gripen Aircraft Project" in ICC, *Countertrade: Offset Contracts* (ICC, Paris, 1989) at 78.

72 Article XVI:2 of Agreement on Government Procurement.

73 Dodds, "Offsets in Chinese Government Procurement: the Partially Open Door" (1995) 26 *Law & Policy in International Business* 1119 at 1141. The GATT Secretariat's first Trade Policy Review of Israel said: "Under Israeli law, a counterpurchase clause must be included in contracts for purchases valued at more than US$500,000 made by government agencies, State corporations or State-assisted institutions." XIII(18) *Countertrade Outlook* (September 25, 1995) at 1.

requirements fall within the coverage of the Agreement, a State signatory may implement offset programs in contravention of the Agreement, so long as the issue is not referred to the WTO.[74] In sum, this Agreement is not binding on the WTO members who have not approved it. In respect of those WTO members approved the Agreement, it has many exceptions and qualifications.

1.4. Conclusion

With the exception of Article XVI of the Agreement on Government Procurement, there is no reference to countertrade in the WTO documents. Lacking a definitive prohibition on use of countertrade, the WTO Agreement can be read from different angles to prove the consistency or inconsistency of countertrade practices with general principles of the WTO. Balance-of-payment difficulties, debt problems, the prevailing non-tariff trade barriers in developed countries' markets, and the need for heavy infrastructure projects have resulted in developing countries regarding countertrade as a solution. Developed countries also use countertrade for their own reasons such as supporting allies,[75] strengthening military cooperation, gaining access to high-technology, and returning home some expenditures incurred in buying defence equipment.[76]

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74 For example, Singapore, a signatory to the Agreement, has imposed a mandatory civil offset policy for contracts worth S$10m or more. XV(6) *Countertrade & Offset* (March 24, 1997) at 5.

75 For example the US Government supported the Jamaican Prime Minister, Edward Seaga, through the bartering of Jamaican bauxite against agricultural commodities. Lee, "Bauxite for Butter: The US Jamaican Agreement and the Future of Barter in US Trade Policy" (1984)16 *Law & Policy in International Business* 239 at 247.

76 Offset programs have been used by Western European countries, Australia and Canada for military purposes. Schaffer, *Winning the Countertrade War,* (Wiley, New York, 1989) at 48. In accordance with an offset policy issued on 16 April 1990, "the US Government views certain offsets for military exports as economically inefficient and market distorting." "Offsets in Defense Trade" (1996) 117(9) *Business America* 155 at 157. However, a committee formed at the President's request to review the offsets has recommended:

> Review and modify as necessary current US government policy on offsets in defense trade to respond to the changing nature of offset demands, reflecting both the need for US firms

In the early 1980s, an attempt was made by the US and other Western countries to put countertrade on the GATT agenda to limit or control countertrade practices.[77] An unpublished report on countertrade was prepared by the GATT secretariat to be regarded as the basis for taking certain measures by the Committee. The developing countries, forming a majority of the GATT contracting parties, rejected the notion that countertrade is something against GATT about which GATT should be concerned.[78] As a result, the issue gained insufficient support from the contracting countries to be raised in the GATT forum.

Although there may be some violation of the WTO spirit and specific WTO rules for mandating countertrade, so far the issue has been ignored by the countries involved. Neither GATT nor WTO has taken an official stand against countertrade. The members may see no reason for taking a strong stand against countertrade practices by bringing them under the WTO control and discipline, when the use of countertrade is so widespread.[79] The results of the Uruguay Round showed that governments are reluctant to deal specifically with countertrade. Even in the Agreement on Government Procurement where countertrade as such is restricted, there are a number of reservations from which signatories may benefit, despite the fact that almost all signatories belong to developed economies.

> to remain competitive in international arms markets and the need to maintain our defense industrial base. For example, in instances where the overseas customer requires technical training, the US subcontractor/ supplier could arrange for the training and receive credit toward the offset obligation for doing so. *All parties would benefit from such an arrangement.* The United States should be cautious and not make any decision to unilaterally limit offsets. [emphasis added]

"Offsets in Defense Trade" (1996) 117(9) *Business America* 155 at 167. The US Defense Department was supporting the offset programs in defence related equipment and at times provided guarantees for some of them. Bonker, "Countertrade: A view from the US Congress" in Korth (ed), *International Countertrade* (Quorum Books, New York, 1987) at 151.

77 Parry, "GATT Weighs the Evidence of Discrimination in the Growing Practice of Global Bartering" (September 21, 1984) *The American Banker* at 39.

78 As above.

79 For example, the delegates of many governments participating in a 2-day conference in Kuala Lumpur in March 1997 emphasised that their governments will be continue using offset programs in the civil sector. XV(9) *Countertrade & Offset* (May 12, 1997) at 1.

2. IMF and Countertrade

The International Monetary Fund (IMF) was created in 1944 at Bretton Woods through the participation of 44 nations. The Articles of Agreement of the IMF (the IMF Articles) came into force on 27 December 1945 as the IMF charter of rights and obligations.[80] The second amendment to the IMF Articles, effective on 1 April 1978, is now in force with the membership of 181 countries.[81] The objectives of the IMF, as stated in Article I of the IMF Articles, are:

> (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
> (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
> (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
> (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
> (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
> (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.[82]

By joining the IMF a country undertakes certain obligations determining the value of its currency, refraining from imposing restrictions on its currency exchange, and pursuing

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80 Edwards Jr, *International Monetary Collaboration* (Transnational Publishers, New York, 1985) at 4.

81 Driscoll, *What is the International Monetary Fund?* (IMF, Washington, revised 1996) at 2.

82 Article I of the IMF Articles. The IMF Articles as amended in 1978 appear in *Australian Treaty Series* (No 10, 1978).

economic polices which further growth in an orderly way.[83] The IMF is based on a multilateral government-to-government treaty which imposes certain obligations on member States. Since individuals are not directly subject to these obligations, countertrade arrangements entered into for their own interests have nothing to do with IMF obligations, if these arrangements have not been encouraged or mandated by their governments.

The IMF has expressed concern about the adverse effect of increased countertrade practices on international trading system:

> [T]he proliferation of such practices is detrimental to the maintenance of the multilateral system of trade and payments. Countertrade practices may entail many of the undesirable restrictive and discriminatory practices traditionally associated with bilateralism. Where countertrade practices result from a direct governmental limitation on the use or availability of exchange as such, they entail exchange restrictions and multiple currency practices that may be subject to approval under Article VIII of the Fund's Articles of Agreement.[84]

Countertrade practices are a concern to the IMF for a number of reasons. These reasons include: i) that countertrade is against the IMF objectives; ii) mandating or encouraging countertrade may violate a country's obligations imposed by virtue of the IMF Articles; and iii) countertrade practices can be used to circumvent the requirements imposed by the IMF on a country as a condition to getting access to IMF resources. These concerns will be discussed below.

2.1. IMF Objectives and Countertrade

The IMF views countertrade proliferation as contrary to its objectives to induce countries to establish a multilateral system of payments and to eliminate foreign exchange restrictions,

83 Articles VIII of the IMF Articles.
84 IMF, *Annual Report on Exchange Arrangement and Exchange Restrictions* (IMF, Washington, 1985) at 41.

hampering the growth of world trade.[85] In its 1983 annual report, the IMF made it clear that:

> the Fund is generally concerned with their [countertrade practices] proliferation because they may be seen as undermining the objective of the multilateral trading system, the promotion of which was a basic objective for the setting up of the Fund, and also because they share many of the microcosmic disadvantages that are common in bilateral payments arrangements.[86]

The IMF "policy aims at the elimination of foreign exchange restrictions and the earliest possible establishment of a multilateral system of payments in respect of current transactions between members."[87] Welcoming the reduced reliance on bilateral arrangements, the IMF "urges the full collaboration of all its members to reduce and to eliminate as rapidly as practicable reliance on bilateralism."[88] The IMF's concern about countertrade is not limited to cases where governments encourage or demand countertrade, but rather for its proliferation worldwide even in the absence of governmental influence. Such a general view about countertrade, however, does not create a legal basis against those countries engaging in countertrade practices, unless a countertrade policy adopted by a country violates specific IMF obligations. It is, therefore, necessary to examine whether countertrade polices violate any specific IMF obligations.

2.2. IMF Obligations and Countertrade

A country which adopts particular measures to mandate or encourage countertrade practices may violate its obligations under the IMF, if these measures result in exchange

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85 Article I of the IMF Articles.

86 IMF, *Annual Report on Exchange Arrangement and Exchange Restrictions* (IMF, Washington, 1983) at 46.

87 IMF, *Selected Decisions and Selected Documents of the International Monetary Fund,* (1996) Decision No 433-(55/42) at 380.

88 As above.

restrictions, discriminatory currency arrangements or multiple currency practices. These measures will be discussed here under three subtitles: i) bilateral payment arrangements; ii) discriminatory currency arrangements; and iii) the restriction of foreign exchange transactions.

2.2.1. Bilateral Payment Arrangements

In the countertrade context, the establishment of clearing arrangements between two countries is a form of bilateral payment arrangement under which two countries agree to exchange up to a fixed amount of goods or services over a period of time. Each country sets up an account in a convertible currency to be debited whenever one country purchases from another. While exporters are paid in their domestic currency, the account is debited in the convertible currency under an exchange rate agreed on by the countries. The traders of either country can purchase from one another up to that specific amount without being concerned about the international payment and the exchange rate.[89]

Section 2 of Article VIII of the IMF Articles requires that "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions". Since clearing arrangements give rise to a restriction on the making of payment and transfers for current international transactions, approval needs to be obtained from the IMF. The IMF policy is to reject any request for establishment or maintenance of bilateral payments agreements, encouraging members to terminate such arrangements as inconsistent with Article VIII.[90] As a result, setting up clearing

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89 For a description of clearing arrangements see Chapter 1 pages 33ff.

90 IMF, *Annual Report on Exchange Arrangement and Exchange Restrictions* (IMF, Washington, 1983) at 44-45.

arrangements without IMF's approval violates the member's obligation to not restrict payment for international transactions.

2.2.2. Discriminatory Currency Arrangements

Article VIII(3) of the IMF Articles prohibits members or their fiscal agencies from engaging in any discriminatory currency arrangements or multiple currency practices.[91] This obligation is related only to those State members which have accepted it.[92] A multiple currency practice arises when separate official exchange rates for specified transactions is established.[93] In cases where a bilateral arrangement is set up between two countries, the exchange rate fixed for that arrangement may be different from official exchange rates prevailing in those countries. The practice results in a different exchange rate for those products exchanged under the bilateral arrangement.[94] Similarly, if a State member provides hard currency only to those foreign exporters undertaking a countertrade requirement, this leads to a discriminatory currency practice against those not undertaking such an obligation. A discriminatory currency practice also arises if the government sells foreign currency at a favoured rate to those companies undertaking a partial counter-export commitment. A

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91 Article VIII (3) provides:

> No member shall engage in, or permit any of its fiscal agencies referred to in Article V, Section 1 to engage in, any discriminatory currency arrangements or multiple currency practices, whether within or outside margins under Article IV or prescribed by or under Schedule C, except as authorised under this Agreement or approved by the Fund. If such arrangements and practices are engaged in at the date when this Agreement enters into force, the member concerned shall consult with the Fund as to their progressive removal unless they are maintained or imposed under Article XIV, Section 2, in which case the provisions of Section 3 of that Article shall apply.

92 Article XIV of the IMF Articles; about 44 countries have not accepted yet the obligation of Article VIII, Sections 2, 3, and 4 of the IMF Articles. IMF Home Page on the WEB.

93 IMF, *Annual Report on Exchange Arrangement and Exchange Restrictions* (IMF, Washington, 1981) at 23.

94 IMF, *Annual Report on Exchange Arrangement and Exchange Restrictions* (IMF, Washington, 1985) at 40.

State member, however, may seek approval from the IMF for the introduction of a multiple currency practice. Such approval will be granted if the multiple currency practice is necessary for a balance-of-payment difficulty and if it is not discriminatory.[95]

2.2.3. Foreign Exchange Transactions

Sometimes a State member officially requires that imports in specific sectors should be paid by domestic currency so as to encourage the foreign exporting companies to spend the local currency to purchase domestic products for counter-export or to invest within the country.[96] The government may also put certain restrictions on the use or transfer of local currency paid as the price of goods or services imported. Such requirements are inconsistent with the obligations imposed by virtue of Article VIII(2) of the IMF Articles. Under this Article members undertake not to put restrictions on acquiring foreign currency to pay for current international transactions.[97] The Article also bans putting restrictions on the use or transfer of local currency given for the settlement of those international transactions.[98] Like the previous obligation, this obligation is imposed on those countries which accept it.[99]

2.3. Circumvention of IMF Conditionality

Countertrade may be perceived to be a circumvention of economic policies required by the IMF as a condition for it lending money. Access to IMF credits for those members having

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95 IMF, *Annual Report on Exchange Arrangement and Exchange Restrictions* (IMF, Washington, 1981) at 23.
96 Huh, "Countertrade: Trade Without Cash?" (December 1983) 20 *Finance & Development* 14 at 16; see also Chapter 2, pages 68-69.
97 Article VIII (2)a of the IMF Articles.
98 Edwards Jr, *International Monetary Collaboration* (Transnational Publishers, New York, 1985) at 18.
99 Article XIV of the IMF Articles.

difficulty meeting their financial undertakings is conditional on certain economic policies and adjustments being followed by the borrowing country.[100] The IMF may require the borrowing country to allocate a proportion of its hard currency to service its debts. This requirement limits the ability of the indebted country to import necessities. The country may bypass this requirement through bartering its goods with some products needed to be imported.[101] Since in the barter system exports generate no hard currency to be shown in national income accounts, and consequently to be earmarked for servicing the debt, the country can continue to import without increasing its debt repayments.

Bypassing the IMF requirements is not welcomed by the IMF. It believes such requirements are essential not only for the indebted country to improve its balance of payment but also for the IMF to protect its resources.[102] A senior IMF consultant remarks: "These policies should help a member to overcome its balance of payments problem, avoid the temptation to resort to measures detrimental to itself or to the general welfare, and help it to achieve and maintain a sustainable balance of payments position over a reasonable period ahead."[103] On the other hand, the austerity measures and economic polices dictated by the IMF may not be realistic for a particular country. In these circumstances, the use of countertrade to import necessities may be an option to decrease the rigidity of IMF requirements.[104]

2.4. Discussion and Conclusion

Despite the general IMF concerns, only certain cases of countertrade fall within the IMF's jurisdiction. These cases arise when a State member mandates or encourages countertrade

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100 For a discussion of IMF conditionality see Guitian, "Conditionality: Past, Present, Future" (1995) 42 *IMF Staff Papers* 792.
101 See Chapter 2 pages 87-88.
102 Gerster, "The IMF and Basic Needs Conditionality" (1982) 16 *J World Trade L* 497 at 497.
103 Gold, *Conditionality* (IMF Pamphlet Series, No 31, Washington, 1979) at 2.
104 See Chapter 3 pages 87-88.

practices through restricting current payment for international transactions, discriminatory exchange practices, or establishment of a multiple exchange system. Article VIII(2) permits State members to impose exchange controls with IMF approval. As a result, it is possible to set up a bilateral clearing arrangement with the approval of the IMF.

Apart from obtaining IMF approval, a country may join the IMF through the transactional provisions of Article XIV which permits the member to maintain restrictions on payments and transfers for current international transactions or to adapt them to changing circumstance.[105] Until September 3, 1997, out of 181 members, 137 member States have accepted the obligations of Article VIII Sections 2, 3 and 4.[106] Forty-four countries, however, have availed themselves of the transitional arrangements under Article XIV which permits the member not to undertake the obligations set out in Sections 2, 3 and 4 of Article VIII. As a result, these countries may maintain their restrictions on payments or transfers for current international transactions or continue their discriminatory currency practices. These countries also have the right to adapt their currency restrictions to changing circumstances. They do not need to obtain IMF approval to maintain or adapt such restrictions. It should be noted, however, that introducing new restrictions needs the approval of the IMF in any case.[107]

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105 Section 2 of the Article XIV provides:

> A member that has notified the Fund that it intends to avail itself of transitional arrangements under this provision may, notwithstanding the provisions of any other articles of this Agreement, maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on which it became a member. Members shall, however, have continuous regard in their foreign exchange policies to the purposes of the Fund, and, as soon as conditions permit, they shall take all possible measures to develop such commercial and financial arrangements with other members as will facilitate international payments and the promotion of a stable system of exchange rates. In particular, members shall withdraw restrictions maintained under this Section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner which will not unduly encumber their access to the general resources of the Fund.

106 IMF Home Page on the WEB [http://www.imf.org].

107 Article XIV of the IMF Articles.

As regards the bypassing of IMF conditionality, a country may use countertrade to bypass IMF requirements on the grounds that such economic policies dictated by the IMF lead to "a policy of stagnation, rising unemployment and declining living conditions, while substantial resources are transferred abroad as repayments of past debts."[108] As a result, underdeveloped countries may view countertrade as a way out of IMF prescription which has adverse effects on the basic needs of their populations.

108 The quotation is from the former Finance Minister of Ghana, J H Mensah. Gerster, "The IMF and Basic Needs Conditionality" (1982) 16 *J World Trade L* 497 at 500; see also Saxena & Bakshi, "IMF Conditionality - A Third World Perspective" (1988) 22(5) *J World Trade L* 67 at 67.

3. OECD and Countertrade

3.1 Introduction

The Organisation for Economic Co-operation and Development (OECD) was established in 1961 as the successor of the Organisation for European Economic Co-operation (OEEC).[109] The OECD objectives are set out in Article 1 of the Convention on the Organisation for Economic Co-operation and Development.[110] This Article calls members to promote policies designed:

> (a) to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
> (b) to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
> (c) to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.[111]

The OECD is a developed country dominated organisation which is a forum for international discussion and direct co-operation among its member countries.[112] It provides an opportunity for its members to exchange information and consult with one another before adopting certain domestic economic policies at either an administrative or legislative

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109 For a brief description of both organisations see Van Meerhaeghe, *International Economic Institutions* (Kluwer, the Netherlands, 5th ed 1987) at 172-205.

110 The OECD Convention, which was signed in Paris on 14 December 1960, entered into force generally on 30 September 1961. It came into force for Australia on 7 June 1971.

111 Article 1 of the OECD Convention; a copy of the Convention can be found in the *Australian Treaty Series* (No 11, 1971).

112 The OECD members are: Austria (1961); Australia (1971); Belgium (1961); Canada (1961); Czech Republic (1995); Denmark (1961); Finland (1969); France (1961); Germany (1961); Greece (1961); Hungary (1996); Iceland (1961); Ireland (1961); Italy (1961); Japan (1964); Korea (1996); Luxembourg (1961); Mexico (1994); New Zealand (1973); The Netherlands (1961); Norway (1961); Poland (1996); Portugal (1961); Spain (1961); Sweden (1961); Switzerland (1961); Turkey (1961); United Kingdom (1961); and, United States (1961).

level.[113] Since the OECD has no supranational legal power, its decisions are binding on those members to the extent that the decisions, to which they have agreed, comply .with the constitutional requirements of that country.[114] The OECD is an important international organisation because it covers the largest world economies which produce more than half of the world's goods and services and share much of the global trade.[115] The OECD continuously reviews and analyses elements having an impact on the economic policy of its members, giving advice and providing guides to the conduct of members. The results of these analyses, which are often published by the OECD, constitute a basis for later agreement between the parities.

3.2. OECD Reports on Countertrade

The OECD has carried out a number of research projects to provide its members with an understanding of countertrade, its variations and the reasons underlying its growth. The OECD Development Center[116] carried out a series of case studies on the experience of

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113 Article 3 of the OECD Convention provides:

> With a view to achieving the aims set out in Article 1 and to fulfilling the undertakings contained in Article 2, the Members agree that they will:
> a) keep each other informed and furnish the Organisation with the information necessary for the accomplishment of its tasks;
> (b) consult together on a continuing basis, carry out studies and participate in agreed projects; and,
> (c) co-operate closely and where appropriate take coordinated action.

114 Article 6 of the OECD Convention.

115 Hoekman & Kostecki, *The Political Economy of the World Trading System* (Oxford University Press, Oxford, 1995) at 9.

116 The OECD Development Centre was established in 1962 with the following broad objectives:

> to bring together the knowledge and experience available in the Centre's participating countries of economic development and the formulation and execution of general economic policies;
> to adapt such knowledge and experience to the actual needs of countries or regions in the process of economic development;
> to place the results by appropriate means at the disposal of the countries concerned; and,
> to contribute to a better understanding in the OECD and its Member countries of important aspects of the development process from the point of view of the non-Member countries concerned.

Tunisia[117], India[118], Egypt, Ghana, Nepal and Sri Lanka[119] in relation to barter and barter-like trade. These case studies were published as working documents to be presented to an Expert Meeting organised by the Development Centre in March 1977.[120] A general summary of these case studies has been published by the Centre under the title of "The Development Impact of Barter[121] in Developing Countries".[122] The study concluded that the success of barter trade, which appears rather advantageous for the developing countries, depends on its administration and the economic policy of the country.[123] Although the study emphasised the difficulties which may arise from the use of barter or from heavy reliance upon it, the study did not deny its benefits for these countries if it is used with caution as a complement to multilateral trade. The study suggested that barter "should be employed with caution in seeking short-term economic goals and should guide the way for more multilateral trade."[124]

In 1981, a report entitled "East-West Trade: Recent Development in Countertrade" was prepared by the OECD Secretariat.[125] This report aimed at analysing countertrade practices which were increasingly requested by socialist countries as a component of their trade deals with the West. The research revealed that Eastern countries would continue their demands

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The members of the Centre are all OECD members except Australia, Hungary, New Zealand, Turkey and the United Kingdom.

117 The case study in Tunisia was not presented to the Expert Meeting in March 1977 because Tunisia has abandoned its barter policy.

118 The India case study has published as follows: Banerji, *The Development Impact of Barter in Developing Countries - the Case of India,* (OECD Development Centre, Paris, 1977).

119 The case studies in Egypt, Ghana, Nepal and Sri Lanka were presented to the Expert Meeting and are available as documents in Center.

120 Banerji, *The Development Impact of Barter in Developing Countries - the Case of India,* (OECD Development Centre, Paris, 1977) at 9.

121 Barter in this OECD research paper is a generic term for reciprocal transactions. See Chapter 1, pages 9-10.

122 Outters-Jaeger, *The Development Impact of Barter in Developing Countries*, (OECD Development Centre, Paris, 1979).

123 At 122-125.

124 At 125.

125 OECD, *East-West Trade: Recent Development in Countertrade* (OECD, Paris, 1981).

for countertrade because of their trade deficit with the West and the lack of competitiveness of their products.[126] The report warned Western trading partners not to neglect the impact of such unilateral requirements on multilateral trade, their risks, and their complex nature. The report suggested that the disadvantages of countertrade should be brought to the knowledge of Eastern countries, showing them that short-term benefits of such demands should be counter-balanced with their negative effects over a longer period.[127] The general aim of the report was to provide the OECD countries with background to various forms of countertrade, the reasons underlying its popularity, the potential risks involved, and the way to overcome such drawbacks rather than condemning countertrade practices. The report concluded that encouraging or demanding countertrade by governments is a practice inconsistent with the principle of the multilateral trade system.

The increase in requests for countertrade by developing countries led to a discussion within the OECD in the early 1980s about its adverse effects on the multilateral system of trade.[128] The OECD Executive Committee asked the competent bodies of the OECD to examine the importance of countertrade, its underlying motives, and its implications. As a result, a Secretariat report was prepared and published in 1985 with the title of *Countertrade: Developing Country Practices.*[129] The report found that in developing countries, countertrade is relatively marginal to the whole of international trade and mostly motivated by immediate problems of liquidity. While recognising the short-term benefits of countertrade, the report strongly opposed the idea that countertrade could be a viable basis

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126 At 7.
127 At 8.
128 Such concerns have been mostly raised by the US. For example, the then Secretary of State, George Shultz, at a meeting of the OECD Ministers said: "The Eastern countries, facing lagging exports, are attempting to pay for an ever-larger share of their imports by compensation deals and barter arrangements." Parsons, "The Future of East-West Industrial Cooperation" (November, 1988) 91(8) *Technology Review* 56 at 57.
129 OECD, *Countertrade: Developing Country Practices* (OECD, Paris, 1985).

for a longer-term trade policy.[130] The report added: "Operations which seem advantageous in the short term may very well reveal themselves to be deceptive in a longer-run perspective and this for many reasons."[131]

Some OECD officers, however, viewed countertrade practices as contrary to the free trade policy adopted by OECD countries. For example, Jacques de Miramon, a senior OECD officer pointed out:

> From the point of view of the general interest of OECD countries, which is to safeguard an open multilateral trading system, countertrade is backward: it runs counter to the progress made in liberalising trade since the last World War. It is a return to bilateralism through a modernised barter system. It recalls the restricted choice that is characteristic of wartime economies and compartmentalise markets, whereas the polices pursed successfully for the last thirty years by the OECD countries have aimed at opening markets, increasing opportunities for trade and improving commercial practices.[132]

Such an absolutely negative attitude about countertrade is not in the line with the OECD reports and the behaviour of OECD countries in practice. The OECD report, for example, said:

> Western firms suggest these [countertrade] procedures to countries which close their borders to their exports. This tendency may well continue as a large number of developing countries are facing problems of liquidity. Aware of their difficulties, western banks and trading companies are putting forward the opinion that countertrade is the only means of maintaining trade with their countries. They are very active in promoting these practices. with the claim that they are trying to defend the interests of their western clients. ... Private firms retain freedom of choice for their commercial decisions. If these firms believe they can make a profit through a countertrade operation and that operation does not infringe national and

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130 An OECD officer, De Miramon, having a stronger opposition to countertrade said:

> Such practices divert trade flows, foster an irrational allocation of resources, raise transaction costs and lead to increasing government intervention. Their unbridled development would reintroduce bilateralism into foreign trade on a large scale. The difficulty they cause exporters is out of all proportion to the volume of trade they induce. And there is a danger that countries and firms will copy their competitors and thus spread the disease.

De Miramon, "Countertrade: An Illusory Solution" (May 1985) 134 *OECD Observer* at 24 at 29.

131 OECD, *Countertrade: Developing Country Practices* (OECD, Paris, 1985) at 27. These concerns are discussed in Chapter 3.

132 De Miramon, "Countertrade: A Modernised Barter System" (January 1982) 114 *OECD Observer* 12 at 15.

multinational of trade, governments have no reason to prohibit acceptance of these practices.[133]

3.3. Discussion and Conclusion

The OECD reports on countertrade have dealt mainly with the issue of growing demands for countertrade by centrally-planned or developing countries. The purpose of these reports has been to provide the members with a better understanding of various countertrade mechanisms and their motives so as to equip them against the potential drawbacks and risks inherent in these transactions. The reports have never been intended to provide a basis for controlling or regulating countertrade practices calling on members to restrict such practices or to refrain from engaging in them. At most, the reports are intended to help members deal with increasing demands for countertrade, pointing out its long-term implications to normal trade under a multilateral system. As a result, these reports have not led to an agreement between the members to regulate or control countertrade.

It is less likely that OECD members will take any strong action against countertrade practices through reaching an agreement to control and regulate them. A likely agreement may be concerned with one of the following three issues:

i) There could be an agreement calling on members to control countertrade transactions entered into by private companies with no government intervention. Such an agreement is unlikely to be reached. Imposing specific regulations on countertrade, apart from the usual trading rules, is inconsistent with OECD policy to not intervene unnecessarily in economic activities carried out by the private sector. On the other hand, most OECD countries have

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133 OECD, *Countertrade: Developing Country Practices*, (OECD, Paris, 1985) at 28.

established governmental or semi-governmental agencies to provide assistance and information to national firms to deal with countertrade obligations.[134]

ii) There could be an agreement to call on members and their agencies not to engage in countertrade practices. This decision, which needs the consent of every member, is also unlikely because most members do not want to lose a deal on the grounds that the deal has a countertrade demand, although they theoretically object to countertrade. While no OECD member has outlawed countertrade practices, only the US has declared a tough policy against them.[135]

iii) It is possible that an agreement could impose restrictions on offset programs made for government procurement. Since such a restriction has already been set out in the WTO Government Procurement, it is unlikely to be dealt with once again in the OECD forum. This is particularly so, given the fact that not all OECD countries have signed the Government Procurement Agreement.[136] Moreover, some of the members such as Australia and New Zealand have official offset programs.[137] As a result, in current circumstances, it is not expected that the OECD will reach an agreement in the near future to limit contorted practices within the members or with non-members in the near future.

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134 Carey & McLean, "The United States, Countertrade, and Third World Trade" (1986) 20 *J World Trade L* 441 at 448. For the engagement of British and Canadian firms in countertrade see Neale, Shipley & Dodds, "The Countertrading Experience of British and Canadian Firms" (1991) 31 *Management International Rev* 19; for Japanese firms involvement in countertrade, see Palia, "Countertrade Practices in Japan" (May 1993) 22 *Industrial Marketing Management* 125.

135 "Offsets in Defense Trade" (1996) 117(9) *Business America* 155 at 157-159. A leading US trade union, the International Association of Machinists & Aerospace Workers, called "for business, labor, and government to work together to pass legislation and establish regulations that will limit the ability of foreign customers (both public and private sector) to demand offsets". XIII(17) *Countertrade Outlook* (September 11, 1995) at 8.

136 See above, pages 429-434.

137 As regards to Australia see Liesch, "Government-Mandated Countertrade in Australia" (1994) 23 *Industrial Marketing Management* 299 at 299; with respect to New Zealand see Verzariu, *Countertrade, Barter and Offsets* (McGraw-Hill Book Company, New York, 1985) at 38-39.

Conclusion

The new international trade system is based on the theory of comparative advantage. This theory says that each country has a comparative advantage in producing some products that it could export to its trading partners.[138] Through trade liberalisation, a country could specialise in the production of those goods and services in which it has a comparative advantage and imports those goods in which it has comparative disadvantages. Trade liberalisation increases the overall gains of a country, improves the living standard of a nation, allocates economic resources correctly, and furthers the world production output. Thus, countries should promote trade liberalisation by removing trade barriers and resorting to multilateral mechanisms.[139]

In this respect, international economic organisations, such as the GATT, IMF and OECD, have been established to reconstruct world trade on a liberal, comprehensive and multilateral basis. One of the main concerns of these organisations has been fighting with bilateralism and discrimination which could undermine their objectives. In their eyes, bilateralism has three essential effects: the non-participants are restricted in accessing their markets; the participants are dealt with discriminatorily; and it increases the possibility of governmental intervention in trade issues.[140]

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138 See Ethier, *Modern International Economics* (WW Norton & Co, New York, 2nd ed 1988) at 58.

139 Jackson & Davey, *Legal Problems of International Economic Relations* (West Publishing Co, St Paul Minn, 2nd ed 1986) at 10ff.

140 Bilateralism refers to a policy by which a country attempts to achieve a balance between its import expenditures and its export receipts in respect of individual countries or particular countries; a country makes an import commitment in return for the allocation of an import quota by another to assure a certain trade level; and a country enters into arrangements providing for preferential tariff treatment on a bilateral basis. Kostecki, *East-West Trade and the GATT System* (St Martin's Press, New York, 1979) at 58.

The rapid emergence of countertrade practices has been criticised by these organisations as a return to bilateralism. They have expressed their concern about the adverse impact of using countertrade and its proliferation on the whole international trade system. They have argued that countertrade practices introduce new trends of trade restrictions and bilateralism among countries. Two forms of countertrade, mandated countertrade and clearing arrangements, have been mainly the focus of condemnation: mandated countertrade for government intervention in trade; and clearing arrangements for their bilateral nature.

The theorists of these organisations view the growth of countertrade as a return to a trade system based on preferences, restrictionism and bilateralism. They believe that the impact of countertrade on international trade is the same as other forms of bilateralism which limit trade to the level of participants and decrease their export capacities. Moreover, countertrade may disrupt the normal trade routine by dumping the goods in a market, implementing discriminatory administrative treatments, applying selective monetary control and discriminatory exchange rate policies.

Nevertheless, for many countries, especially developing countries, countertrade is a trade policy to achieve economic or financial objectives. Equally, countertrade is a way for industrialised exporting companies to stay in a market otherwise inaccessible. Trade liberalisation is not a trivial matter. In practice, countries are maintaining or imposing various restrictions on trade for economic, social or political reasons. Moreover, when there is a deep division between the rich and poor and between developed and undeveloped countries, trade liberalisation could result in a great trade deficit and currency crisis for the countries with less economic strength. Trade liberalisation is based on the assumption that each country benefits from trade because it has something in which it has a comparative advantage. In reality, a country may need finance, technology and skills to produce those goods and services in which it has a potential comparative advantage. In particular, the countries which are in a transitional period need to implement certain economic policies to be able to compete in the global marketplace.

Because of these observations, the member States of these major international organisations have not taken strong action against countertrade practices because either they mandate countertrade or they do not want to intervene in countertrade practices entered into by private companies. The issue of countertrade has not gained sufficient support within these forums to lead to a treaty. As a result, there are no international rules controlling or regulating countertrade as such. It is unlikely that in the near future members will reach agreement to control or regulate countertrade practices.

The existing rules of the WTO, IMF and OECD do not concern private companies engaging in countertrade. They are related to cases where a government through legislation or state trading enterprises encourages or demands countertrade. Countertrade policies are generally adopted by developing countries for which the rules of WTO and IMF are more relaxed. Most countertrade policies of these countries are justified on the grounds of preferential treatment prescribed for developing countries. In other cases, however, the applicability of these rules to countertrade is not clear and they may be read from different angles. Although certain countertrade practices may violate some particular rules of the WTO or IMF, so far the issue has been largely ignored by the countries and consequently no official complaint has been launched. Even if an official interpretation were to clearly state that countertrade practices violate these rules, the consequences of breaking the rules might not be effective in preventing countries engaging in countertrade practices.

Conclusion

There is considerable confusion concerning the growth and spread of countertrade practices in today's international trade. On one hand, the international community is heading towards a trade order which is based on multilateralism, non-discrimination and a free market. On the other hand, the 1980s and 1990s have witnessed an explosion of countertrade practices in world trade. At first glance, it seems that the international community is going back to a practice which is not only inefficient in itself but also a threat to liberal internationalism. One of the reasons for this misguided view is that countertrade appears to resemble barter in the sense of a simple exchange of goods for goods without the intervention of money. The first step in dealing with this confusion is to establish some grounds for defining countertrade and for determining its functions.

Countertrade is a generic term covering a broad area of economic activities by which two sets of obligations from two opposing sides are connected to each other. In other words, under these arrangements an exporting party is required to undertake certain counter-obligations to the benefit of the importing party which are extra to the obligations generally undertaken by an exporter under a conventional transaction. For example, the exporter may be required to manufacture certain products in the importing country's territories, to invest there, or to help the importer to access world markets, obtain advanced technology, finance a research project or develop a tourism industry. These various obligations are additional to what an exporter generally undertakes under a typical trade arrangement. Thus, the essence of countertrade is that the exporter undertakes a counter-obligation to the benefit of the importer.

There is no consensus as to the arrangements which should be classified as countertrade and those which should not. Countertrade comprises a wide spectrum of contracts from simple deals to complicated long-term arrangements which are to be fulfilled over years. There is certainly an overlap between countertrade on one hand and joint ventures, investment, licensing, sale of goods and services, construction, distributorship and concession agreements on the other. Countertrade is not a new term for the old practice of exchange of goods for goods. Defining countertrade as a moneyless transaction is not only inaccurate, because of the money involvement in almost all countertrade cases, but also deceptive, because it implies a backward turn to a pre-money era. Countertrade is a new development in international business in line with the new international economic order which emphases, inter alia, the right to development and the principle of sovereignty over natural resources and economic activities.

The basic function of countertrade is to involve foreign trading partners in the importing country's development and economic growth. An importing country which has to spend a lot of money on buying expensive military hardware or costly projects wishes to benefit from its huge expenditure through putting pressure on its trading partner to invest some of that money in the importing country or to help it in certain economic activities. The principle of countertrade is: 'You scratch my back and I'll scratch yours'; I'll buy from you, and not from others who may offer a better price, if you help me in other ways. Today, countries are reluctant to permit the export of their natural resources or capital without gaining significant benefits for their own economic growth and development. Such a view is not restricted to countries suffering from a hard currency shortage seeking to finance their purchases. Countertrade is a response to attitude changes in countries which seek to gain greater benefits from their purchases and deals. It indicates a new trend in international business with fewer countries wanting to remain mere purchasers. Thus, countertrade may be used in different economic environments by developed and developing countries alike. Countertrade is not a practice exclusive to developing or centrally-planned countries. For example, countries like Australia, Canada, UK, Belgium and Spain are requesting countertrade as a condition for their military purchases or government procurement. Similarly, less developed countries in Africa, Latin America and Asia are demanding countertrade from their trading partners as a condition of doing business with them. The difference between them lies in their expectations from countertrade and the kind of assistance they look forward to receiving in return.

Countertrade practices are here to stay as long as the reasons for them exist. When industrialised countries are not ready to help less developed countries tackle their economic difficulties, and while a division between rich and poor countries remains, countertrade is seen as a viable mechanism for less developed countries to pressure their trading partners for further participation. While government intervention to mandate a countertrade policy may be viewed as coercive and distortive of global trade by some Western countries, it is seen as a national development strategy for the governments using it. It is too optimistic to believe that in the near future these countries will find easy alternatives enabling them to give up countertrade policies.

This does not mean, however, that countertrade is free from risks and difficulties for those requesting countertrade and those responding to it. Two different attitudes to countertrade exist. One approach is to condemn it as a restrictive, bilateral and discriminatory practice which is a threat to what the international community has achieved since World War II for the internationalisation and liberalisation of world trade. The senior staff and secretaries of international economic organisations such as the GATT, IMF and to some extent the OECD, have such a negative view of countertrade practices. Alternatively, countertrade is viewed as an intelligent response to the extensive gap between developed and underdeveloped economies, to liquidity crises, to growing protectionism in developed countries, to the heavy dependence of these countries on exports of primary commodities and to the growing need for advanced technology and project financing. To those who see it like this, denying the existence of countertrade or underestimating its significance is not helpful to those needing to use countertrade either as an exporter or importer. UN bodies, like ECE, UNCITRAL and UNCTAD, have taken such a positive approach and have taken measures to help those participating in these transactions.

This research has been based on a positive approach to countertrade and designed to minimise the risks associated with countertrade practices. Countertrade transactions, if they are planned and drafted carefully, can be useful for business people to devolve new markets or to overcome economic difficulties. Countertrade contracts are a cross-border phenomenon and a complex practice. They therefore require certain precautions in their planning and drafting. Because of the international character of countertrade contracts, those drafting them need to be aware of the diversity of legal, political and cultural differences at play which may affect the deals. The risk of misunderstanding is considerable when communications are between persons with different cultural backgrounds, languages and traditions. One of the major areas of difficulty is the legal complexity and uncertainty surrounding these innovative and reciprocal transactions. Since countertrade is generally composed of a number of contracts, countertrading parties have to deal with drafting individual contracts as well as with providing a linkage between these individual contracts in the light of the parties' expectations and needs.

There are hardly any rules in national or international laws dealing specifically with countertrade and consequently its legal issues must be managed by reference to traditional contract law and other commercial regulations. The problem with national laws is that they have been developed largely in a national context and in relation to conventional transactions. They may not always provide satisfactory solutions to problems arising from these linked contracts.

It is, however, advisable that the planning and drafting of countertrade contracts should be done in the light of a specific national law, chosen as the governing law, because the governing law provides a context in which countertrade contracts are to be construed. This contemplation helps the parties to determine the necessary terms which should be inserted into the contracts. It also helps them to predict the legal implications of the contract as a whole and the meaning of its individual terms. Since the governing law has a gap-filling function which completes the issues upon which the parties fail to agree, the parties should reach their own agreement on those issues if they are not happy with the residual rules of the governing law.

In addition to paying close attention to the applicable law, the Vienna Sales Convention and its application to their particular countertrade contracts should also be assessed. The Convention may apply to their contracts by force of law in many countries if the parties fail to exclude its application. The application of the Convention to a countertrade contract by force of law depends on whether the contract will be determined as a "sale of goods" within the meaning of the Convention. Different courts or tribunals may reach different conclusions on this issue. Thus, it is wise for the parties to make clear whether or not they want to subject their contract to the Convention. If the Convention is to be chosen to govern the countertrade contract, it may be necessary to adapt some of its provisions in the light of their particular needs and the reciprocal nature of the deal.

Those involved in drafting countertrade contracts may wish to leave little to be decided by national legal systems. There are two options for them to minimise the impact of the governing law. One is to draft the contract in detail, predicting every major issue which may arise. The other is to draft a moderate contract, affixing to it a set of general conditions which are appropriate for a particular countertrade contract. In drafting a detailed contract, the parties need to refer to previous experience and work carried out by others, especially the work done by international organisations. Standard countertrade contracts and standard terms benefit the parties by saving money and time otherwise needed to draft contracts for each case and on a term-by-term basis. Standard contracts are also useful as guidance to the major issues which should be inserted into the contracts. Although standard contracts are not free from disadvantages and drawbacks, careful use of them makes life easier for those drafting countertrade contracts.

As an alternative pathway for pursuing clarity and certainty, the parties may affix a set of general conditions to their contract, according to which the contract is to be effective. The UNIDROIT Principles of International Commercial Contracts are a set of general rules which illustrate the modern trend of contract law in an international context. Although they have not particularly been drafted for countertrade purposes, the rules are broad enough to deal with many major issues. It is recommended that the parties choose them as a framework for their general rights and obligations arising under a countertrade contract. If they do this, however, they certainly need to complement these rules by drafting specific terms to reflect the particular needs and the reciprocal nature of the deal.

Another problematic area of drafting countertrade contracts is choosing a format for connecting the obligations of two opposing sides of the deal. A countertrade package is generally composed of a number of individual contracts which need to be connected to each other. A protocol is often drafted as a thread to various components of the countertrade package. A great concern about using protocols and other preliminary agreements is that they may not be enforceable in some legal systems, especially if the protocol is a framework for further negotiations or for subsequent conclusion of individual contracts. One remedy to this problem is to draft the protocol in as detailed a manner as possible or to provide some machinery for determining the terms left undecided. Alternatively, an applicable law can be chosen which is in sympathy with protocols and contracts with open terms.

In sum, countertrade practices are here to stay in international business. There is a degree of softening in countertrade condemnation and it is not expected that the international community will take a strong position against countertrade. It is also unlikely that a set of uniform rules, like the Vienna Sales Convention, will be drafted for countertrade purposes. The legal issues of countertrade should be managed by self-regulatory contracts which predict the major issues arising. To decrease the intervention of national laws, a dispute resolution clause may be inserted into the contract to submit any disputes to a particular court or to arbitration. In planning and drafting countertrade contracts, lawyers should adopt a flexible approach to the practice of law to provide legal services which are best suited to the needs of the trading parties. In practice, they may face different variations of countertrade transactions or new mechanisms. It is not enough for them to know what the practices are today. They also need to be aware of the future trends in this field.

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