

## **From Legal Aspects of Export Transactions**

### **EXPORT CONTRACTS**

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United States businesses selling goods and services in other countries may use various types of commercial arrangements to accomplish their goals. Many of the different kinds of international transactions present common legal issues. This article summarizes the most widely used contract types and the legal issues they present.

#### **Sales Agency and Distribution Agreements**

Most companies which are new to international business begin by employing an export manager who engages distributors or agents in key markets. A distributor is an independent contractor who buys goods and takes title for its own account and resells them. The distributor is responsible for warehousing and delivery, bears the credit risk, and earns a profit by buying at a discount and reselling at a higher price. In contrast, an agent functions like an employee by soliciting orders and forwarding them to the principal for acceptance. An agent does not take title to goods. Normally, the agent is compensated by payment of a commission which is usually calculated as a percentage of sales.

In many countries, if a manufacturer has a choice between appointing an agent or distributor, the manufacturer will appoint a distributor. Where the manufacturer has appropriately limited the authority of the distributor, a distributor is less likely to be protected by labor laws, or to be considered a "permanent establishment" subject to local taxes under the provisions of a bilateral tax treaty.

#### **Licensing Agreements**

When transportation costs and local government regulations make it impractical or impossible for a company to sell its products in a foreign market, it may "sell" its knowledge of how to make the products by licensing its intellectual property rights, such as its patents, copyrights, trademarks, or trade secrets.

One of the greatest concerns for United States licensors is the inadequate protection of patents, trademarks, and copyrights for computer software in many developing countries. Also, many countries have special restrictions on licensing agreements. There may be a requirement that local law govern the agreement or that the agreement be pre-approved or registered with a local agency. Some countries establish caps for royalties and related fees. Other jurisdictions have enacted special "technology transfer" legislation requiring that licensed technology rights become the full property of the licensee after a specified period.

## **Joint Venture Agreements**

Once United States businesses reach a certain level of local market penetration, they may acquire a local distributor or enter a joint venture with a local producer. By producing locally, the exporter can enhance its “presence” and avoid or reduce tariffs and transportation costs. For example, MERCOSUR (the Argentina-Brazil-Paraguay-Uruguay trade block) has a 20% maximum common external tariff and 0% internal tariff on most products. An exporter producing within MERCOSUR does not have to pay the external tariff. Also, if a United States business bids for a privatized company or participates in an infrastructure project, it will usually work with a local partner.

Good joint venture partners will take care of tasks that are more difficult or impossible for foreigners, such as:

- Dealing with government regulators
- Selling to local government agencies (which are often required by law to “buy local”)
- Obtaining real estate and zoning permits
- Managing employees
- Adapting products and services to local requirements and tastes

Joint ventures may be “housed” in a newly created company separate from the owners. Typically, two parties contribute resources on a 50/50 basis in exchange for ownership. In other cases, the United States partner may buy a large enough block of shares of a local company (at least 20 to 25%) to allow it to have an active role in management. Alternatively, partners may simply sign a contract to work cooperatively. Joint ventures may be formed to complete one project only (like a construction project), for the duration of a patent or concession, for a trial period, or for an indefinite period.

## **Franchise Agreements**

Franchising, which has elements of both distribution and licensing, has become a widely used method for international expansion of fast food restaurants, hotels, theme parks, temporary personnel agencies, and travel agencies. The franchisor licenses the right to sell products or services using the franchisor’s trademark and system of operation in return for an initial payment and royalties based on sales. The franchise agreement often provides for standards of quality control and reporting to which the franchisee must adhere.

United States franchisors frequently employ master franchise agreements in which the franchisor grants the right to develop a foreign territory to a sub-franchisor. The sub-franchisor may own some units and franchise others to third parties. In some cases, a United States franchisor may seek local joint venture partners who will share an equity investment in the market.

## **Infrastructure Project Agreements and Other Service Contracts**

International infrastructure and construction projects may be completed as turn-key project agreements which set out the responsibilities of the contractor or vendor to finish the project and “turn the key” over to the purchaser for immediate use. Variations on the turn-key arrangement include “BOT” (build-operate-transfer) agreements, “BOO” (build-own-operate), “BOOT” (build-own-operate-transfer) and “BLT” (build-lease-transfer) agreements, all of which provide that the builder operate the facility for a specified time period to obtain a guaranteed return before transfer ownership to another entity.

Other service providers, such as management and technical consulting, architectural design, environmental and civil engineering, and custom computer programming firms often contract to sell their services to foreign clients. Banks are an example of service providers that may establish subsidiaries in other countries to access foreign customers.

## **U.N. Convention on Contracts for the International Sale of Goods (CISG)**

The United Nations Convention on the International Sale of Goods (CISG) automatically applies to contracts for the sale of goods between a buyer and a seller located in different countries that have ratified the CISG unless the parties “opt out” by specific written exclusion. Many of the CISG’s provisions are comparable to those found in Article 2 of the Uniform Commercial Code (UCC) adopted in the United States. Specific similarities may be found in the provisions of the CISG and the UCC on warranties, course of dealing and usage of trade, excuse, remedies, and adequate assurances of performance.

There are some major differences between the CISG and the UCC. For example, on the issue of contract formation, the CISG contains a strict “mirror image” rule requiring an acceptance to be only of the strict terms of the offer. In contrast, the UCC allows for greater discrepancy in the terms of acceptance which may have different terms than those in the offer provided the differences do not alter the material terms of the offer. Under the CISG rules, a reply that purports to accept an offer, with modifications, is a rejection of the offer and constitutes a counter-offer. Under the UCC, a reply to an offer that contains different terms that do not materially alter the terms of the offer constitutes an acceptance unless the offeror, without undue delay, objects orally or in writing to the discrepancy. If the offeror does not object, the terms of the contract are the terms of the offer including the modifications contained in the acceptance. Therefore, an exporter should quickly send a letter of objection or clarification to the buyer if there is any discrepancy between the exporter’s offer and the buyer’s acceptance. Failure to convey such objection could result in an unwarranted contract where the UCC and not the CISG applies in such a negotiation.

## **International Contract Terms (INCOTERMS)**

INCOTERMS are a set of internationally recognized trade terms published by the International Chamber of Commerce (ICC) located in Paris, France. These terms include definitions such as parties, terms of sale, point of origin, place of delivery, cost of shipping and

insurance, and which party is responsible for obtaining export and import clearances. For example, CIF (Cost-Insurance-Freight) is a pricing term that indicates that cost, insurance, and freight to the port of destination are included in the quoted price. In such case, the buyer is responsible for the transportation of the goods from the port to the buyer's inland location.

When both parties specify that delivery shall be according to INCOTERMS, there need be no dispute regarding at which point the exporter's responsibility ends and the importer's begins. However, the specification must include the year of publication of the INCOTERMS to be used since this publication has been released several times with varying definitions within the revisions for the same or similar terms.

## **Contract Terms**

Terms to be covered in agency, distribution, and licensing agreements include:

- Products to be handled (agency and distribution) or rights granted (licensing). The exporter may later develop a new product and not necessarily want to commit to a relationship with the same local partner regarding this product.
- Term. The term of an agent or distributor should be for a defined period and rarely for a period more than three years. It is not advisable to commit to automatic renewal because of the possibility of incurring termination compensation.
- Marketing, service, and financial reporting duties (agency and distribution) or quality standards (licensing). For example, an agent or distributor should contractually agree to:
  - submit sales forecasts and reports on the activities of competitors;
  - maintain premises in a manner that will reflect well on the exporter;
  - provide inspection, maintenance, and repair service;
  - maintain adequate levels of product on hand; and
  - furnish regular financial reports.

The agreement should specify that breach of these provisions will result in a final warning letter or a breach with a reasonable period of cure before the breach is determined to be a default. Warning letters are important to document the representative's failure to measure up and counter any claim that the termination was arbitrary.

- Grounds for early termination, including failure to meet minimum purchase (distribution) or sales (agency) quotas, or failure to make royalty payments (licensing). The exporter should research the market to determine realistic goals. In some countries, failure to meet objective standards is the only acceptable reason for termination of agency or distribution agreements. Alternatively, if the

representative exceeds performance goals, the exporter may consider increasing the representative's discount or commission.

- Consequences of termination, such as:
  - return of customer lists and documents containing trade secrets
  - cooperation with transfer of accounts to a new representative
  - repurchase of inventory
  - cessation of use of trademarks
  - post-termination confidentiality
  
- Territory/Exclusivity – The agreement should be precise in specifying the kind of exclusivity granted (for instance, whether it grants a territory in which no other representatives will be named, limits the manufacturer's right to sell, or limits the representative from selling competing products). Further, the local jurisdiction's competition laws should be reviewed to determine whether exclusive arrangements are permitted with representatives. The exporter should be careful about granting a new representative the exclusive right to sell its products in more than a limited geographic area and whether the representative should be limited to a product line or to specific channels of distribution. Broad exclusivity should be withheld until the representative proves himself by meeting performance requirements. It is easier to expand the territory of a distributor who does a good job than to reduce the territory of a distributor whose results are disappointing. In any event, the exporter should reserve to itself the right to sell directly into the territory.
  
- Payment – Letters of credit make it easier to collect payment from foreign customers because the buyer must pay the purchase price to a bank before obtaining the commercial and shipping documents that allow him to claim the goods. Letters of credit give a higher level of security but are also expensive for buyers and may render the product or service non-competitive.

Joint venture agreements usually cover the following main points:

- Contribution of cash, services, equipment, facilities, or technology.
- If buying part ownership, valuation of the local company.
- Determination of the shares and directors which the United States partner may receive or obtain (assuming that the joint venture will be a corporation).
- Control of managerial decisions. Supermajority approval is usually required for a handful of key decisions, such as selecting top managers, changing the product line, declaring dividends, monetary commitments over 10% of net worth, initiating lawsuits, and selecting accountants and lawyers.

- Compensation of the United States partner. Provided the choices are consistent with local law, parties can choose to distribute all profits as dividends based on percentage of ownership, to pay no dividends for initial period to allow venture to build up capital, or to take as dividends a percentage of profits. The United States partner should also be paid for related licensing, management, or components supply agreements based on a flat fee or a percentage of sales or both.
- Termination events - valuation and buy-out.

### **Contract Formation and Procedural Formalities**

While the CISG does not require a written contract, some countries have statutory schemes that impose many formal requirements to form a contract. Notarization, registration with a government agency, and even preliminary approvals may be required for certain contracts in some jurisdictions. Notarization is a more complex and formal process in civil law jurisdictions. Also, letters of intent should clearly state what the parties are committing themselves to do. Failure to specify the allocation of expenses can result in a party being responsible to pay the expenses of the party in a failed negotiation.

### **Intellectual Property Protection**

Before expanding overseas, an exporter should register its trademarks in its name in each target market. It is important not to permit the local partner to register the exporter's trademarks in the name of the local agent or partner. Also, the exporter should place appropriate copyright and confidentiality notices on information about processes, products or services, customers, and personnel. Finally, the agreement establishing the relationship with the local partner should provide that:

- The exporter owns all intellectual property in its products or services, including any translations, adaptations, enhancements, and new versions;
- No ownerships will be transferred to the local partner;
- The local partner and its employees will sign confidentiality and non-compete agreements; and
- The local partner will notify the exporter immediately upon learning that a third party is infringing or threatening infringement of the exporter's intellectual property.

### **Exchange Controls**

The exchange control regime of the foreign country should be understood to identify risks to be managed through contractual provisions, insurance, or other mechanisms. Contracts should address such issues as: (i) payment currency, (ii) currency of denomination specifying

amount payable, (iii) availability of foreign exchange and (iv) restrictions on repatriation of capital.

## **Dispute Resolution**

The risk of disputes can be minimized by choosing local partners carefully and by negotiating clear, written contracts. However, despite the most thoughtful planning disputes may arise. As long as the courts of the local partner's country enforce arbitration clauses and awards, binding arbitration will be the preferred method of resolving most disputes. The main advantage of arbitration is that the parties can decide beforehand who the arbitrators will be and where they will hear the case. The alternative may be competing court proceedings in the United States and the local partner's country. Contracts should usually require non-binding but formal negotiation or mediation prior to arbitration. If such efforts fail, binding arbitration follows.

## **Compliance with United States Foreign Corrupt Practices Act (FCPA)**

Companies having dealings with foreign government agencies or state-owned enterprises should take steps to ensure compliance with the FCPA. This law prohibits offering or giving "anything of value" to any foreign official or public sector employee "corruptly" to obtain or retain business. Large gifts and lavish entertainment are presumed illegal. The law also prohibits such payments through local partners. Minor "facilitating payments" to expedite the performance of routine actions, such as speeding up licenses and customs clearances, are allowed. Also, as a general rule, the law does not prohibit giving promotional samples of products, or reimbursing foreign officials to travel to the United States to meeting with company personnel and visit facilities. The Act imposes civil and criminal penalties for violations. Recently General Electric Company paid \$69 million and Lockheed Corporation paid \$24.8 million in fines and penalties for alleged violations of the law. In addition to adopting and enforcing FCPA policies and procedures, exporters should provide formal training regarding the FCPA to employees and local partners involved in marketing to public entities. "Red flags" include requests that commission payments be made to bank accounts in third countries or to third parties, and requests for cash or unusually large commission payments.

## **Conclusion**

While doing business internationally can be intimidating, the use of appropriate contracts and contractual provisions can help exporters manage the risks involved and maximize the rewards.