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AUTOMOBILE SUBCONTRACTING WITH THE DEVELOPING COUNTRIES 1/

by

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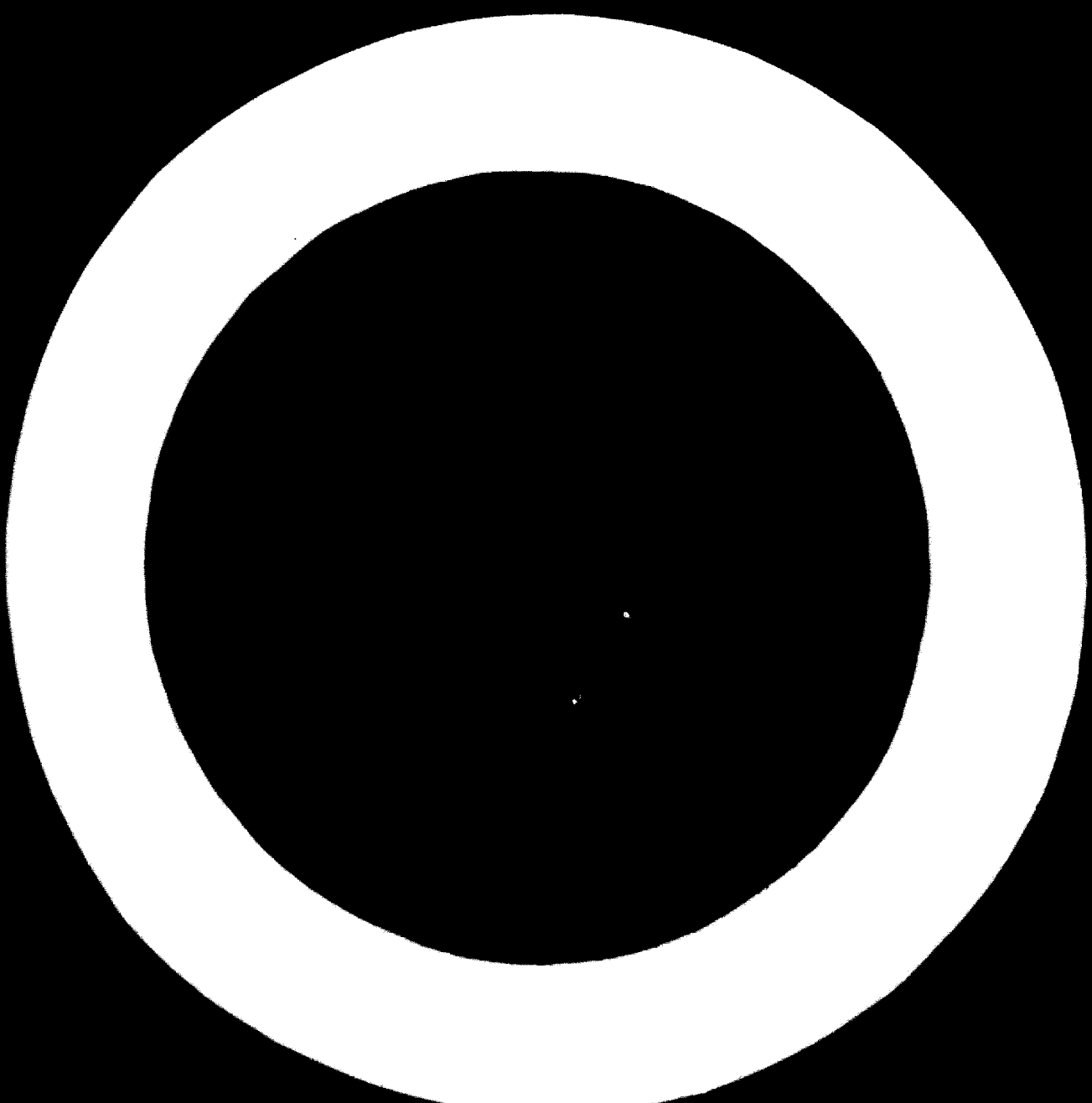

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INTRODUCTION

"It is the greatest economic challenge of this century to bring economic prosperity to the developing countries." It is true that economic challenges are, or at least have been, fashionable. None the less, this comment is worth harkening to in view of the fact that it was made, not by a political figure or leader of a developing country, but by one of the members of the Board of Directors of Unilever, Dr. Piter Kuin, in a report by the Commission on International Investments and Economic Development of the International Chamber of Commerce.

This comment, then, very clearly shows the desire not only of the developing countries to acquire the know-how and technical capabilities to enable them to raise the level of their economic development, but also of the industrialized countries to see this take place.

Can international subcontracts and licensing agreements be a way of achieving this?

The present study is intended to study only the first of these two subjects, namely international subcontracts. Licensing agreements will be considered separately by Professor Burst, Professor at the University of Strasbourg and director of the Centre for International Industrial Property Studies.

It is, however, evident that there are necessarily areas of overlapping between the two problems, and it is hoped that any repetition or trespassing will be excused.

* * *

DEFINITIONS

We must obviously attempt to define international subcontracting.

Subcontracting would appear to be perfectly simple to define. For a builder or an industrialist, it consists of having something done rather than doing it himself. So we come back to the very traditional idea of job work.

In the French national planning office, under the vigorous leadership of the President, Mr. Pinet, a subcontracting charter was established in May 1972, for the purpose, if not of genuinely codifying, then at least of endeavouring to standardize subcontracting practice. This document proposes the following definition of subcontracting: "Subcontracting in the broad sense of the term refers to all the production or work which an enterprise assigning work or placing orders can entrust to a specialized enterprise, known as a subcontracting enterprise, working in accord with it or following its directives.

The field of subcontracting covers both the production of part of an assembly or some of its fittings and also that of parts or components entering into the manufacture of finished products. It often relates to operations carried out on a jot basis on parts or products entrusted to the subcontracting enterprise by the prime contractor. It may take in some services."

The same subcontracting charter also draws a distinction between the supplier and the subcontractor:

"The subcontractor, with a view to meeting the particular needs of his customer, agrees to conform to his directives with regard to the definition of the characteristics of the order and sometimes even its execution."

"The supplier himself plans and manufactures his own products, calculating the needs of the market."

One point of resemblance between the prime contractor and the manufacturer can be found in the idea of "initiative", which sets them apart from the subcontractor.

Normally, the prime contractor takes the initiative with regard to the manufacturing, which is entrusted to the subcontractor only for execution.

The supplier also takes the initiative for the creation of his product, which he offers to various manufacturers or builders for use in their production.

At the stage of definitions, attention should also be drawn to the traditional distinction between the capacity and speciality types of subcontracting.

Capacity subcontracting refers to the situation where the prime contractor, generally for economic reasons, asks an outside enterprise to manufacture a product it requires which it cannot produce in adequate amounts.

Capacity subcontracting represents a low-grade economic, and hence legal, relationship beoause it generally bespeaks the subordination of the subcontracting enterprise, which is more or less at the mercy of the prime contractor enterprise which, after its market has been satisfied, may leave the subcontracting enterprise without work.

Speciality subcontracting, on the other hand, unquestionably involves a better economic, and hence legal, relationship. Under this type of subcontracting, the prime contractor assigns part of his manufacture on a more permanent basis to a subcontractor

who is particularly highly qualified by his technological knowledge or know-how. The balance of the contract is obviously better, since it is usually more difficult for the prime contractor to get rid of the subcontractor in view of the technological implications of this type of relationship.

Speciality subcontracting is one of the key elements in the distribution and specialization of labour.

At the national level, the implementation of subcontracting encounters significant difficulties which this is not the place to consider, but which can be relatively easily solved since all these matters are governed by private law and therefore are by accord freely debated by the two parties concerned.

On the other hand, at the international level, subcontracting problems are complicated to a very great degree by a very wide range of considerations, of which we shall examine only the following, in order to simplify this paper:

(a) Not only are the actual languages different, but also the modes of expression, in that these involve a certain respect for usage, custom and the "rules of the game". Therefore, "definitions" must be drawn up in each instance, making reference to common standards which, despite the substantial efforts made by a number of international organizations, are generally not very numerous and little used.

(b) The agreements between the prime contractor and the subcontractor are no longer subject to private law alone, but also fall in the sphere of public administrative and tax law, as legislated by each country. This consideration is of very special importance for developing countries where the economy is at least to a large degree in the hands of the State.

(c) While at the strictly national level, the prime-contractor enterprises and the subcontracting enterprises are at virtually comparable economic levels, the same is not true in the developing countries, whose levels of industrialization differ widely.

This problem of levels is, furthermore, of essential importance in this study because it must be remembered, as pointed out by the rapporteur of a United Nations Conference on Trade and Development, that since the situations in the developing countries vary considerably from country to country, it would not be possible to divide the countries into two groups - the developed and the developing countries.

These introductory considerations lead to the first of the conclusions which it is imperative to bear in mind. In view of legal, economic, political and social differences referred to above, there is an infinite number of possible subcontracting agreements between developing and industrialized countries, and to undertake an exhaustive examination of the problems which may arise and the means of solving them would be, if not a super-human task, at least one which would mean going into very great detail and could not be dealt with in the framework of this paper.

The more modest aim of this paper will be to attempt to outline the problems which may emerge in these international agreements, at three levels:

- Conclusion of agreements and possible types of agreement,
- Implementation of agreements and related problems,
- Penalties for non-performance and ending of agreements.

This approach moreover in a way harmonizes with the rhythm of life, since it reflects the birth, life and death of these international agreements, and it is true that the products of man's activities do not escape the destiny of man himself.

I. CONCLUSION OF AGREEMENTS - OUTLINE OF POSSIBLE TYPES OF AGREEMENT

The importance, and also the enormous variety of subcontracting situations in the broadest sense of the term as regards automobile manufacturing is well illustrated by the information given by the Union of French Automobile Workers (November 1970):

"More than 485 lines in 73 countries throughout the world now assemble, partially manufacture or manufacture under licence motor vehicles produced by all the major producer countries (the United States, Japan, the Federal Republic of Germany, the United Kingdom, France, Italy, the USSR and Sweden). Their rate of production ranges from one (or even less) to 950 vehicles a day, and the necessary installations belong either to subsidiaries of major manufacturers or to local enterprises. In the latter case, the enterprise sometimes manufactures various makes of car, and in this event its factory has several lines ... nearly thirty projects for the installation of new lines have been announced in the last two years."

A. THE HISTORICAL ASPECT

In fact, these highly diverse situations are the result of successive stages in and approaches to the establishment of plant, which can be outlined as follows:

(a) In the first stage, the developing countries import finished products outright. This was almost universal with the developing countries until the Second World War. In this situation, local economies do not profit in any way from these imports.

(b) In the period following the war and above all after the 1950s, the first assembly plants appeared. At this stage, developing countries purchase sets of parts outright, either as CKD (completely knocked down) vehicles shipped in the form of separate parts, or as components having undergone partial assembly in the workshops of the SKD (semi-knocked down) manufacturer. At this stage, then, developing countries incorporate, if not products as such, then at least labour, into the commodities supplied on their markets.

(c) Beginning in the 1960s, the developing countries demanded incorporation of a larger proportion of locally manufactured parts and components, and the assembly lines therefore turned more and more often into partial manufacturing enterprises. It is easy to bring about this first shift because at least 25 per cent of a motor vehicle is made up of components which can relatively easily be incorporated, such as upholstery, tyres and various electrical components such as batteries or coils.

Furthermore, various manufacturers exerted pressure on their suppliers in industrialized countries to set up factories in the proximity of the assembly lines which could themselves produce in the developing countries materials to be incorporated into vehicles.

It can be seen that at this stage there is no genuine subcontract in the narrower sense of the term, but a contract for the supply of goods for assembly, affording the advantages with regard to tax implications which that assembly can have for the manufacturer, since a vehicle assembled in the country can enjoy certain tax reductions.

(d) In recent years, a period began in which the assembly of vehicles imported in CKD or SKD form must give way to virtually full production from domestically produced components.

This is where subcontracting as such appears, since engine, chassis or body work components can be locally manufactured only when a patent or licence is granted, not to speak of the essential factor of transfer of know-how and the technical assistance which is inseparable from it.

At this stage, the capital participation by the prime manufacturing companies also increases. Thus, a relatively complex contract arrangement covering financing, the granting of a licence, provision of know-how, technical assistance, stocking, transport and marketing arises.

(c) Lastly, the final stage consists in setting up an establishment, either through the conversion of already existing facilities or through the direct installation of facilities in which the vehicle can be fully manufactured. In fact, if this type of full investment is to be made, the developing country must have reached a stage in which it possesses economic infrastructure which will make it possible to provide all the ancillary services and supplies required for the proper operation of such facilities. The examples which it has been possible to give and which will be considered in the following chapter in fact only relate to countries which had already reached a certain level of industrialization. Here we have genuine "joint undertakings", which obviously go beyond the limits of subcontracting as it is traditionally understood.

In this situation, the developing country no longer appears "dependent" with respect to the original manufacturer, since there are a number of examples of lines installed, for example in Mexico or Argentina, which carry out 95 per cent assembly of vehicles using domestically manufactured products.

Paradoxically, it can be maintained that it is now the industrialized countries which, in respect of the 5 per cent coming from them, are "economically" the subcontractors of the countries which have thus completed their development. This reasoning obviously must disregard the interests which original manufacturers may have in these enterprises in the form of capital.

B. THE ECONOMIC ASPECT

In an article devoted primarily to subcontracting problems in the Far East, to which this paper will from time to time refer, Mr. Susumu Watanabe distinguishes three types of international subcontracting. His criterion is the market.

1. Commercial subcontracting

This is the situation where a company, to meet the needs of its domestic or international production, entrusts the manufacturing of items required to foreign enterprises. The items thus manufactured outside the country are then delivered to the customer, either through the intermediary of the prime contractor company or directly by the subcontractor manufacturing them under the trademark of the prime contractor company. Mr. Watanabe points out that in this situation, the prime contractor company can be said to play the part of a trading company.

This type of subcontracting is very widespread where labour-intensive techniques which do not require sophisticated equipment are involved. Mr. Watanabe gives schibori production as an example. This is a silk cloth used for luxury kimonos, the production of which has traditionally been centred in Kyoto.

A schibori is a very closely woven cloth approximately 10 metres long and 40 centimetres wide, exactly the right size for one kimono. First of all, 85,000 to 150,000 (an average of 100,000) tiny knots are made and the fabric is then dyed before being used for making kimonos or other items. For an average worker, 100,000 knots represent at least one week of work.

Since there is a growing shortage of the necessary labour in Japan, the schibori manufacturers in Kyoto have had to entrust this work to an enterprise in South Korea, where this technique was introduced before the Second World War. The prime contractors in Kyoto send their orders to Korean business firms (22 in 1970) which share them out in the agricultural districts, distribute the raw material and come to collect the finished products. Mr. Watanabe says that, in 1970, schibori exports amounted to $34 million and that the work was done by approximately 150,000 seasonal or part-time workers.

This type of subcontracting, where work is entrusted to craftsmen or small-scale productive units, is also very commonplace in Europe in the field of wearing apparel. A large proportion of the ready-made apparel sold in France is partly manufactured in the Eastern European countries, and also in the developing countries. A department store in the Champs Elysées has its production manufactured in Pakistan.

2. Industrial subcontracting across national borders

Under this arrangement, the prime contractor has foreign enterprises manufacture parts and components, which are assembled by its establishments in its own country. Consequently, these items must cross one or more frontiers after being manufactured. A very well known example in the field of automobile manufacturing is Volvo, which had approximately 2,200 subcontractors in the Spring of 1971.

According to information made available by this firm, only approximately 500 of these were Swedish, and the rest were in the Federal Republic of Germany, Canada, the United States, France, Japan, the United Kingdom and other countries. Of the

parts and components purchased, 42.4 per cent came from Sweden, 28.8 per cent from the countries of the European Economic Community (mainly the Federal Republic of Germany) and 24 per cent from the countries of the European Free Trade Association (mainly the United Kingdom).

As can be seen from this example, although this type of subcontracting is very widespread among industrialized countries, especially in the field of the automotive, and perhaps the aero-space industries, it is in fact at present virtually non-existent with the developing countries.

There are examples of industrial subcontracting across national borders involving certain European prime manufacturers and East European countries such as Poland, Yugoslavia and Romania. This involves manufacture under licence with technical assistance and the establishment of stocks in the country of the prime manufacturer in order to alleviate the effects of any interruption in supply.

There are, however, also encouraging examples of this type of subcontracting with developing countries. One of these relates to the Nissan motor works.

Since this company receives orders for a small number of models which are not mass produced, it turns to a firm in a neighbouring developing country for the manufacture of the bodywork and has the vehicles assembled in another firm, while the engines and chassis are produced in Japan. The bodywork enterprise, which shows great ingeniousness, has brought out a number of variants of its own design, and its workshops now use such highly perfected processes (thanks partly to the free technical assistance from Nissan) that the Japanese enterprise holds it up as an example to industries in other developing countries.

An example of this type of initiative is the manufacture of small lorries whose cabs are fitted with back seats in addition to the bench seat for the driver and his assistant. These lorries, which are especially designed for use in cities, where traffic conditions make it necessary to keep the length of stops to a minimum, make it possible to transport helpers for loading and unloading.

Another similar example is that of a European prime manufacturer which specially produces in its African or Asian establishments a vehicle which is different from its domestically produced vehicles and is specially adapted to the requirements of the local market. The importance of this production is increasing, and it is planned to produce 3,000 vehicles of this type in 1973.

According to the author of the Japanese study, "this type of industrial subcontracting across national borders will become increasingly widespread as industry in the developing countries becomes more efficient. However, for the time being it is still not very commonplace, in contrast to international commercial subcontracting, which, at least in some areas, has for some time been spreading remarkably".

3. Domestic industrial subcontracting

Mr. Watanabe includes under this term the subsidiaries which fully manufacture the product in the country, partly with components supplied by local enterprises and assembled in the workshops of the prime contractor in the country. In this case, the products manufactured under subcontract do not leave the country. It must be pointed out, however, that this definition by the Japanese author differs from UNCTAD's, according to which the two parties must be located in different countries if there is to be international subcontracting, but may be a parent company and its subsidiary.

In fact, this distinction is fairly arbitrary, since as a rule the capital of the companies involved comes partly from the prime manufacturers and partly from local industrialists or the Government of the country in which the subcontracting work is to be carried out, and these companies are "joint undertakings", which may be said to embody the fully developed and comprehensive form of international subcontracting.

It is very interesting to note that in fact Mr. Watanabe's classification essentially fits in with the historical background which has been given, since technology and capital must normally follow one another in a successful transfer.

Commercial subcontracting must come first, followed by industrial subcontracting across national borders and then domestic industrial subcontracting.

C. THE LEGAL ASPECT

On the basis of the two aspects discussed above, the legal aspect can be divided into two parts.

Since international commercial subcontracting is not very widespread in the automotive industry, it cannot be considered at greater length in this paper.

The following therefore remain:

- Industrial subcontracting across national borders, which, as regards the commodities covered by the paper, can be called partial subcontracting, and
- Domestic industrial subcontracting, which can be referred to as full subcontracting.

Partial subcontracting

As regards industrial subcontracting across national borders, or partial subcontracting, apart from the fact that it is not very highly developed primarily legal problems relating to the granting of licences or transfer of know-how, which are to be dealt with by Professor Bust, are involved.

(a) Licence contract

It is therefore out of the question to expand on this point, and I shall simply point out that these contracts for the granting of licences should define:

- What is being granted with the transfer of patents and technical documents,
- Reassignment prohibitions and manufacturing secrets,
- The duration of the agreement, generally with an obligation of secrecy for a set period following the end of the agreement,
- The technical assistance,
- Possibly, a manufacturing monopoly for the prime contractor,
- The quality controls which are generally to be carried out on the manufacturing line itself.

(b) Transport contract

- Transport contracts are usually annexed to contracts for manufacturing licences. It is obviously very desirable that the contracting parties should refer in these to existing international agreements on this matter.

Let us recall that the main agreements are the following:

- Brussels convention, incorporating the Hague regulations,
- SIF (International Convention on the Carriage of Goods by Rail, 1931),
- CMR (Convention on the Contract for the International Carriage of Goods by Road 1956),

- TIR Convention (Customs Convention on the International Transport of Goods under cover of TIR Carnets),
- TIF model (International Treatment Declaration for Goods under Customs Control carried by Rail),
- The Customs Convention on containers, 1956.

As regard the latter, it must be pointed out that preparatory measures for defining what should be included in a convention on combined transport of goods were studied by the International Maritime Committee, in co-operation with the International Chamber of Commerce, at a meeting in Tokyo in April 1969. In June 1970, in Rome, UNIDROIT, the Institute for the Unification of Private Law, considered these problems. The fact that the concept of containerization is gaining acceptance throughout the world emphasizes the urgent need for a combined transport document applicable to all types of transport.

It should also be pointed out that the United Nations Economic Commission for Europe (ECE), on a Swedish proposal, established an inter-governmental Working Party on the Simplification and Standardization of Export Documents. The work of this group led to adoption by ECE in 1963 of a standard form and the publication in 1966 of a guide containing very full plans for a series of documents based on this standard form.

The developing countries cannot be too strongly urged to refer to these standard contracts wherever they exist. For example, an international transport convention was annexed to a contract concluded between European prime manufacturers and an Eastern European country because both of the countries which were parties to the contract were signatories of the convention.

Lastly, to conclude this list of efforts to simplify and standardise international transport, reference should be made to air-freight, which can be particularly advantageous for the transport to and from developing countries of goods which

are not heavy. In this connexion, IATA (the International Air Transport Association) has prepared a standardized waybill which, however, is appropriate only for this particular means of transport.

(c) One final remark will place industrial subcontracting across national borders in relation to commercial subcontracting or the fully developed kind of subcontracting which will be considered below. This type of subcontracting is in fact a sort of medium-term agreement because it pre-supposes that the relations between the prime contractor and the subcontractor are more or less perennial and are therefore very obviously a factor of economic stability and at the same time of better international organization of labour.

In this respect, it differs both from commercial subcontracting, which is primarily capacity subcontracting and, owing to some degree of precariousness in the relations involved, can be looked upon only as a short-term operation, and also domestic industrial subcontracting, or full subcontracting, which constitutes a long-term operation in the sense that it involves substantial investments.

"Domestic" or full Industrial Subcontracting

It will be recalled that the term "domestic" is used because the whole arrangement takes place within the developing country.

It is the most highly developed form of subcontracting, but it must be pointed out once again that it can only be contemplated in countries which have already achieved a level of economic development offering the necessary industrial background for such an arrangement.

This kind of system is certainly out of the question, even as part of a prestige operation, for countries which do not already have an industrial set-up enabling them to produce various accessories, if only for the maintenance or repair of the vehicles manufactured (nuts and bolts, minor electrical appliances, etc.).

This possibility must nevertheless by analysed, because it is, one might say, the final end of industrial development in developing countries. The existing examples of the establishment of such joint undertakings in countries which have already achieved a certain level of industrial development indicate what are the main elements of the various agreements governing this kind of subcontracting.

(a) Main elements

1. Preliminary contract. Before the signature of the agreement itself there is generally a preliminary contract of a technical nature to establish the capacity of the market and the kinds of vehicles that should suit it.

2. The contract then sets forth the aims and objects, i.e. the estimated production capacity, together with the number of vehicles to be produced, in accordance with a time-table.

3. Questions relating to the input of capital are decided. There are many such questions, including the total amount of capital and the share of each of the partners in the joint undertaking. Control and majority problems are, of course, thoroughly discussed. It is common for such joint undertakings to have three partners, the original manufacturer, private industrialists and the state in which the plant is established. Obviously this kind of agreement is only possible if the State is one under whose political system capitalist or mixed companies are permitted. The terms governing the transfer of the capital invested, and where appropriate its exemption from taxation, are laid down. Bank contributions, often with the participation of a State bank, are also fixed. It is decided what form the shares shall take and the rules governing the disposal of shares are laid down. Governments often insist that their agreement must be obtained before shares are transferred to foreign third parties and reserve various rights of pre-emption in the event that the original subscribers of capital wish to dispose of some of their shares.

The conditions upon which "imported" capital can be re-exported to the country of origin must be determined. It is also necessary to establish the terms governing the remuneration of capital and profit margins, which obviously themselves depend on production costs and selling prices.

The conditions governing the re-investment of profits have also to be decided, developing countries often requiring a large proportion of profits to be re-invested in the country.

4. These fiscal aspects of the taxation of earnings in developing countries have been given special attention by the International Chamber of Commerce, which has published a small pamphlet (No. 197) indicating the various privileges or exemptions that developing countries can offer to private or public investors who might establish joint undertakings in their territory.

These privileges and advantages obviously vary from one country to another, but they can be classified under four headings:

(a) Rate of tax on corporate profits. This rate is obviously very variable. Among the lowest are Hong Kong with 12.5 per cent and Morocco with 20 per cent. But the average rate is generally between 30 and 45 per cent. One of the highest is India with 51.5 to 81.5 per cent. These rates are given subject to any changes that may have occurred since the publication of this study.

(b) Exemption of profits from tax for varying periods from the time of the investment. Many countries allow such exemptions for a period of 5 years.

(c) Special allowances against taxable profits. The most general method is to allow higher rates of depreciation.

(d) Other special fiscal measures can also be taken. We shall merely cite two examples, subject to the same reservation as in paragraph (a) above:

Ghana: Rate of corporate profits tax - 40 per cent; exemption from profits tax for five years (before deduction of depreciation) for all new industry; rapid depreciation rates - buildings 10 per cent, equipment 40 per cent, mining expenses 20 per cent. In addition, the shareholders are exempt from profits tax as long as the company itself is exempt. There are specially low rates for small companies;

Haiti: Maximum profits tax - 30 per cent; all new industries are allowed a reduction of 50 per cent on their taxable income for the first year and 20 per cent for the second; if the industry is a new one for Haiti, the 20 per cent reduction applies for a further four years.

It should be pointed out, however, that investors are faced with the danger that advantageous fiscal provisions may be changed by Governments unilaterally, either because of the economic or political situation, or in order to persuade joint undertakings to accommodate the Government's wishes.

Joint undertaking agreements should also establish:

5. The status of the foreign staff needed, the time by which they will be withdrawn and the terms on which their remuneration will be paid locally and may be transferred to the country of origin.

6. The increasing share of "domestic" goods to be included in the products of the joint undertaking. There are agreements which stipulate that the percentage of local value added must increase with the number of vehicles produced.

7. The industrial cost price of the vehicle, and the technical and financial factors to be taken into account in calculating this price.

(b) Practical schedule

The technical plan should lay down the various stages of production. The development schedule will then appear as follows:

Promotion of local supporting industries. The contract stipulates that within the shortest possible period from the start of production the joint company will purchase from other local industries parts that do not require a special automobile technology, such as windows, seats, etc. The manufacturers undertake to provide local industries with technical specifications for the parts, technical advice and technical assistance. The joint company will order such parts from local manufacturers under firm purchasing programmes to the extent that the parts meet the specifications set by the manufacturers. Some of the locally made parts and products, such as outer and inner tyres, batteries and paintwork, will be used in the vehicles from the start of production by the plant.

A list is drawn up of other parts to be bought from local industry.

The next stage is to promote the manufacture of parts under licence. The contract may stipulate that the manufacturers shall buy specific parts in the country of origin from suppliers who hold exclusive manufacturing rights and patents for such parts.

These parts may include the following: radiators, exhaust pipes, starters, generators, distributors, windscreen wipers, headlamps, shock absorbers, dashboards. The contract may provide that: "The manufacturers undertake to put their suppliers in contact with potential local suppliers of these specific parts, so that the latter may negotiate arrangements under which they are granted licences to manufacture. The joint company shall have the right, subject to the prior approval of the manufacturers as regards quality, to obtain equivalent pieces from these local suppliers".

Once these two initial phases have been completed, the production of mechanical parts proper takes place in two stages, according to the level of manufacture reached:

Assembly of engines, maching of the following major parts:

Cylinder blocks, sleeves and steering wheels;

Second stage - machining of the following major parts:

Pistons, oil pumps, water pumps, induction pipes, exhaust manifolds, crankshafts, connecting rods, cylinder heads, camshafts.

The contract may also state that if certain pieces are available from local industry on acceptable terms as regards price and quality, the joint company may give them preference.

* * *

Finally, such agreements also deal with questions of marketing, technical assistance, settlements, time-limits, guarantees and penalties.

These are matters that have to do with the activities of the enterprise once it actually exists, which leads us quite naturally, after considering both theoretically and practically the types of agreements and the procedure for concluding them, to examine the way in which they are applied, as regards the execution of the sub-contracts, the penalties to which they give rise and their termination.

* * *

II. IMPLEMENTATION OF AGREEMENTS AND RELATED PROBLEMS

It is obviously impossible to draw up a complete catalogue of the problems that may arise during the implementation of these agreements, because, as has already been made clear, there are great differences between them as regards both their scope and the level of development of the countries involved. The problems are as varied as the economic field itself. We can therefore only deal with the most outstanding cases.

According to the International Chamber of Commerce, as indicated in the report on an inquiry made in 1964 by the Commission on Asian and Far Eastern Affairs (CAFEACCI) into the difficulties encountered by international joint undertakings established in Asia, the problems are as follows:

1. Excessive Interference by the Local Government. Effect on Marketing and Re-exporting

Although it may claim to be in favour of sub-contracting and foreign capital investment, the local Government often insists on vetting foreign investment. "Government intervention" can take various forms. The fiscal aspect has already been mentioned above. In addition, there are incentives for enterprises to re-export part of their output, even if under the contracts concluded with the prime contractor or investors, the products are reserved for local consumption or a particular market. This problem proves in practice to be very important.

Some contracts on the establishment of motor works quite logically include protectionist measures for the prime manufacturers. These measures may include the following:

- A ban on the granting of equivalent advantages to other car manufacturers by the Government of the State concerned for a period fixed in the contract;
- An undertaking not to export the output of the new plant outside the national territory or a particular market. This question of re-exporting is in fact very important for the prime manufacturers, since it is hardly acceptable that goods produced under licences granted by them and at works set up with their participation should be sold on other markets at prices lower than they could offer themselves.

In the present state of affairs this possibility is fairly theoretical, because the production lines set up in developing countries usually produce at higher cost, but it could happen that in future years the situation might change, because of the lower labour costs in developing countries and the amortization of the original investment.

Direct action by the State to fix selling prices could obviously lead to the same result.

2. Too Hasty Replacement of Senior Foreign Personnel by Local Personnel

The importance of planning and technical aid in connexion with the practical implementation of subcontracts has already been stressed. It would not even be too much to say that in our view this is the decisive factor in developing the international transfer of know-how.

It would thus seem to be in the interests of both parties to arrange for personnel from the industrialized countries to stay for relatively long periods so that they can give local personnel technical training. It has already been stated that comprehensive subcontracts contain certain sections covering the status of the personnel, and in particular fixed-term contracts may be envisaged. The Commission of the International Chamber of Commerce makes the point that some Governments tend to limit the stay of foreign personnel, replacing senior staff by local staff before the latter are really up to the work.

3. Rate of Royalties

Mr. Watanabe, in the study already referred to, also emphasizes this problem. He says: "People in the developing countries do not seem to fully realize, either, how much time and money is needed in the industrial countries to develop new techniques. In Japan, for example, small and medium-sized enterprises sometimes spend sums larger than their authorized capital on acquiring such techniques, whereas it often seems that many enterprises in the developing countries imagine that they can get them free. We agree entirely with Baranson when he says that most Governments in developing countries tend to underestimate the run-in problems incurred in implanting acquired technology. These Governments have argued that foreign investors should 'place less reliance on the profit motive' and 'should consider technical know-how as something to be shared with developing countries'. The more adverse the environment and the

more complex the technology, the more resources it takes to effect the transfer and the less willing or able a corporation may be to effect the transplant, unless adequately compensated (Jack Baranson, Technology Transfer Through the International Firm)".

From the practical standpoint, it is obviously in the interests of developing countries for their Governments to subsidize visits to industrialized countries by managerial or technical staff capable of training local personnel in their turn. Another problem of equal importance in the same field is the speed of adaptation to new techniques. Some studies stress the slowness of the people of certain developing countries, which is often aggravated by the instability of the labour force.

The existence of this situation in some developing countries thus leads to the third difficulty stressed by the International Chamber of Commerce in its study, i.e. restrictions on the payment of royalties on industrial property and know-how which may be regarded as "excessive".

4. Financing - Offsetting

The fourth point mentioned by the Commission is the difficulty of getting the necessary funds.

This problem arises in connexion with the original investment, but also with the payment of royalties or payment for sets of parts. It is obviously an essential one.

The International Chamber of Commerce sums the problem up as follows: because of the lack of development of the capital market in developing countries, enterprises suffer from systematic financing difficulties; it is also difficult to get loans in convertible currency from the international agencies because the terms they fix are too stiff.

It is in fact in order to find a remedy to this problem that a counterbalancing arrangement has for some years now been provided for in subcontracting agreements.

These arrangements are becoming more and more widespread. They exist not only in relations between industrialized countries and Eastern countries, but also between industrialized countries and subcontracting countries. They amount to a sort of barter economy,

in which in order to produce the currency necessary for the payment of royalties or payment for sets of parts, the industrialized countries have to buy various other products manufactured in the developing countries, whether in the field of engineering or some other field.

Some big European manufacturers have now developed a system of getting third-party companies to seek out and select products which can be supplied in order to offset the supply of technology or sets of parts or machine tools. It has been reported, for example, that one developing country plans to pay for part of its imports of sets of parts by exporting sports wear in return.

It should be noted, that this counterbalancing method undeniably represents progress for international trade, because it enables the developing countries to secure outlets in the industrialized countries which in other circumstances might not necessarily buy the products in question.

5. Taxes

This question, the fifth point raised by the Commission, has already been discussed, but we must emphasize the importance for the developing countries of the temporary admission system, i.e. importing free of tax products to be incorporated in manufactured goods which are subsequently re-exported. Many countries apply this system.

This policy is obviously of benefit to France when it acts as subcontractor. It is also obviously of benefit to the developing countries. In addition, as part of their policy of aid to the developing countries, various industrialized countries have introduced customs exemptions for manufactures produced in the developing countries. The granting of such reduced-tariff quotas by the industrial countries for certain manufactures produced in the developing countries, possibly for a transitional period, could enable them to sell such products at competitive prices without artificial assistance and could thus stimulate world trade.

But apart from the five kinds of difficulties mentioned by the ICC Commission, there are others which deserve to be noted.

6. Quality Control and the Problem of Failure to Meet Specifications

Subcontracts should specify the precise conditions governing quality control of manufacture. It is obviously preferable that such control should be carried out on the first sample produced, by the prime contractor and the subcontractor jointly.

A method which is becoming more and more common is to call upon a third party to act as a sort of arbiter on problems that may arise in this connexion, both technically and from the manufacturing standpoint. Thus one European manufacturer has arranged that in the event of a dispute as to the quality of the product, an international technical institution which is a third party in relation to the contracting parties shall be brought into play. This third party is designated in advance in the contract. There is not an arbitration clause as such; the contract simply designates a neutral expert whose assistance can be sought promptly if any technical problem arises or any dispute as to whether the product is up to quality standards or meets the specifications.

The use of such third parties to verify that goods meet the specifications at the time of their delivery is an institution already known to international trade law, in the field of transport. Some international conventions refer to such control by third parties. Thus the Economic Commission for Europe, in its general sale conditions No. 410, states that the parties should indicate the procedure for approval and may decide in their contract that a certificate issued by the competent authority of the exporting country attesting that the quality of the goods is in conformity with the terms of the contract shall be a substitute for the procedure of receipt.

It should be noted once again that it is highly advisable to refer to the texts drawn up by the Working Group on the International Sale of Goods of the United Nations Commission on International Trade Law. Article 44 states that whether the goods are in "conformity with the contract, including the sample or model, shall be determined by their condition at the time when risk passes. However, risk does not pass because of a declaration avoidance of the contract or of a demand for other goods in replacement, the conformity of the goods with the contract shall be determined by their condition at the time when risk would have passed had they

been in conformity with the contract. The seller shall be liable for the consequences of any lack of conformity even though they occur after the time fixed in the preceding paragraph if the lack is the fault of the seller or any person for whom he is responsible".

The following articles, in particular article 47, regulate the manner in which the lack of conformity is to be established and notified (the text says that this shall be done within a reasonable time). Article 50 states that a buyer who has given due notice of such a lack of conformity has a choice, subject to articles 53 and 56, between the following three alternatives:

(a) To declare the contract avoided, subject to articles 55 and 57, and to claim damages as provided in articles 96 to 100;

(b) To reduce the price in the same proportion as the value of the goods at the time of the conclusion of the contract has been diminished because of their lack of conformity with the contract, without prejudice to the damages provided for in article 94 where appropriate;

(c) To require that the deficiency caused by the lack of conformity should be made good through the damages provided for in article 94.

7. Hidden Defects

A related problem is that of hidden defects, for which there is really no international solution, each country having its own legislation on the matter. French law recognizes two kinds of faults in an article sold: apparent defect and hidden defect.

In determining whether an article is in conformity with the terms of the contract, the purchaser normally only takes into consideration apparent defects. Under the French system, when a purchaser discovers an important defect which was not apparent at the time of delivery but was anterior to it in its origin, it is classified as a hidden defect and the purchaser can invoke the special regulations relating to it. According to the standard French authorities on the subject, Aubry and Rau, "the seller is liable for hidden defects in an article sold if it is thereby rendered unfit for the use for which it is intended".

This problem of the hidden defect is particularly tricky in industrial matters, because such defects can only appear after the product has been used for a certain time. Each case has to be considered individually, on the basis of such expert appraisals as are usually ordered. There is one case, however, in which the manufacturer who sold the article is normally liable to a penalty: when it can be established that defective goods were knowingly delivered and that the manufacturer or seller used various technical means to conceal a defect which became apparent subsequently.

The rule Fraus omnia corrumpit is applied here.

8. Deadlines

The problem of deadlines also arises. They should obviously be fixed, either by contract or by correspondence.

Penalty clauses are usually included in the contract, fixing in advance the amount of the penalty per day or week of delay.

In practice various subcontracts provide that the prime contractor shall keep part of the goods supplied in stock, specifically in order to avoid any breakdown in supply. The conditions governing remuneration or protection of this stock should be laid down in the contract.

9. Payment Guarantees

This involves the whole problem of bank guarantees, which obviously cannot be dealt with within the context of this paper. Prime contractors are entitled to demand security or guarantees or to insist on financing by bills, possibly with commitments by State banks for large-scale operations.

In purely private operations, difficulties arise because of the fact that the developing countries' balances are generally in deficit so that financial organizations hesitate to commit themselves. The United Nations Secretariat estimates that the accumulated deficit of the developing countries in 1970 was of the order of 20,000 million dollars. These problems can in fact only be dealt with in the context of the activities of the big international and governmental organizations, which lies outside the field of this paper. We may merely note in this connexion the measures taken by IBRD (World Bank), IMF, GATT and OECD.

It has also been suggested that a multilateral investors' insurance scheme should be set up and that their body should undertake arbitrage in matters of investment. Because of the close interrelation existing in economic affairs, these questions of payment guarantees for subcontracting operations are obviously essential for the satisfactory development of subcontracting.

III. PENALTIES AND ENDING OF AGREEMENTS

The material treated under this head, which might be expected to be the most legal, will in reality be very brief for two reasons.

At the economic level there is no real "end" to these subcontracting agreements, but an evolution which seems to lead to one of two situations:

- Either the conversion of the subcontractor into a real supplier as the result of a progressive improvement in his technology in regard to a particular product, which should enable him to offer it for sale on advantageous terms to different prime manufacturers, provided, of course, that there is no exclusive contract with any one of them;
- Or the formation of independent manufacturing units which in practice no longer need to maintain relations with the original manufacturers and which thereby achieve genuine independence in due course.

Economic penalties

However, although this evolution is obviously the one to be desired, accidents may very well happen on the way. Thus Mr. Watanabe is able to state in a note to his study:

"States in the Third World are sometimes so eager to succeed that they require the subsidiaries of foreign companies which are already established in their territory or which are considering establishing themselves there, to accelerate their purchases of locally manufactured parts and components at a truly excessive rate. The foreign companies then often move out of the country in question or decline to establish themselves there. In one State in South East Asia, for instance, the Government, wishing to create an automotive industry out of nothing, required interested foreign concerns to undertake to use 30 per cent of locally manufactured parts during the first year and 50 per cent at the end of two years, under pain of confiscation of part of the capital invested ... Since the country had no automobile component factory whatsoever, these conditions seemed unacceptable to the companies concerned (Asahi Shimbun Tokyo, 22 May 1971, morning edition). We ourselves have come across similar cases in the course of our inquiry."

This example shows that the penalties in international agreements are really far more economic or political than legal or judicial.

The case reported above shows the action that capital can take against an attitude of the developing countries which is considered too extreme.

Political penalties

Conversely, the developing countries may well penalize capitalist concerns which do not respect contractual commitments or the "rules of the game", either by fiscal constraints or, in extreme cases, by nationalization or confiscation of the capital.

In view of the importance of the interests at stake, the issue then passes out of the legal or even economic sphere and becomes purely political.

In addition, at this stage attention must also be drawn to the prime importance which the industrialized countries attach to factors of political stability when deciding to engage in subcontracting operations with developing countries. This type of contract requires a degree of permanency which can be endangered by manifestations of political instability.

Force majeure

In order to provide the greatest possible protection against such manifestations, it can happen that the agreements treat them as cases of force majeure. Although in municipal law "force majeure" is often interpreted in an extremely restrictive way, it is not impossible, in international agreements, to give it a wider interpretation. Thus one full subcontracting agreement defined force majeure as follows:

"By force majeure is understood an event which is independent of the will of the parties to the agreement, unforeseeable and insurmountable, such as fire, explosion, floods, earthquakes, storms, hurricanes, wars, strikes, technical unemployment and Government restrictions which may be introduced after the entry into force of these agreements and which prevent the total or partial fulfilment of the obligations contained herein."

In cases of force majeure one of the parties can immediately release himself from his obligations.

Judicial control

That brings us to examine, in closing, the judicial control which can be exercised over these agreements.

The fantastic diversity of private and public international law means that in practice an arbitration clause is very often included in these agreements. Nothing, however would prevent one of the parties from imposing its own municipal law on the other by stating that any disputes that might arise out of the agreements must be settled by its own courts.

Nevertheless, before a judgement handed down by the court of one of the parties can be executed, the matter has in principle to be brought before the court of the other party in whose country the decision is to be implemented, since only a municipal court can order its enforcement.

The case must therefore be brought before two instances in turn, with all the implications which that entails, since even if the application of a particular legal system is provided for in the contract, each instance will have a natural tendency to apply the principles of its own private international law and, in particular, to apply the rules of public policy which may be relevant.

International arbitration

Consequently, provision is made for recourse to an international court, generally under the auspices of the International Chamber of Commerce, since both parties then agree to accept the jurisdiction of that court.

Normally, therefore, the case has to be brought before only one court, not two.

The arbitration clause usually refers to the Rules of Conciliation and Arbitration of the International Chamber of Commerce, whose headquarters is in Paris, which specify the conditions in which the arbitration must take place. The Rules of Conciliation and Arbitration, which can easily be obtained from the International Chamber of Commerce, lay down the conditions on which a dispute may be brought before it, the preliminaries to conciliation, the choice of arbitrators, the arbitration procedure as such, and the conditions in which the arbitral award must be pronounced and notified. Article 29 stipulates that:

"Irrevocability and enforceability of the award.

1. The arbitral award shall be final.
2. By submitting their dispute to arbitration, the parties undertake to carry out the subsequent award without delay and waive their right to any form of appeal, insofar as such waiver may be valid."

Even if, as is most desirable, in the arbitration clause (i.e. that paragraph of the agreements which provides for arbitration) provision has been made for the specific application of a particular municipal law, in judicial practice - and contrary to what the above-mentioned article 29 might lead one to think - it is always possible for one of the parties, generally that to which the award is unfavourable, to bring the case before its own municipal court, since the article provides that the parties waive their right to any form of appeal 'insofar as such waiver may be valid'.

However, as stated above, in order for it to be possible to enforce the arbitral award in one of the countries of the contracting parties, it must receive, in advance, an "exequatur", which can only be conferred by the judicial authority of the country concerned. Each country, however, has its own legislation governing the conditions on which an international arbitral award may receive the exequatur. If, for example, it is established that the arbitral award concerned is contrary to national public order or that the defendant's rights have been disregarded, the municipal judge is not obliged to allow the international award.

A specific example of an international dispute

A specific example, deliberately taken from outside the motor industry, where legal disputes seem to be few and far between, will illustrate the difficulties and delays involved in litigation.

A European mattress company had acquired the rights to a patent owned by a United States company. The licensing agreement provided for arbitration by the International Chamber of Commerce and for the specific application of the law of Maryland.

A difficulty arose while the contract was being executed: the mattress manufactured in Europe with the United States process failed to satisfy a number of technical tests which would have entitled it to the benefit of a label which, although not really essential for the marketing of the mattress, would have improved its chances.

The European manufacturer therefore decided not to produce the mattress, and the owner of the United States patent instituted proceedings before the International Chamber of Commerce for the annulment of the agreement and for substantial damages.

The International Chamber of Commerce set up a court of arbitration consisting of a French professor of law nominated by one of the parties, a French international lawyer nominated by the other party, with a leader of the Netherlands bar as chairman.

For almost two years the parties exchanged pleadings; the proceedings were made difficult because of the technical problems involved and because the arbitrators had to be supplied with the elements of Maryland law applicable to the case.

The International Chamber of Commerce was therefore repeatedly obliged to extend the time limits granted to the arbitrators for the filing of their award and, faced with such lengthy developments, the defendant brought the case before his own municipal commercial court. Subsequently the arbitrators handed down, by a majority, an award stating that

the European manufacturer was at fault in breaking the contract because the requirement that a technical standard should be respected had not been requested when the licensing agreement had been signed. To enforce the award the United States plaintiff had to bring the matter before the president of the court in the country in which the plaintiff had its head office, with a request that the international award should receive the exequatur.

By a judge's order the court allowed this request, but the defendant immediately challenged the order before the competent court on the ground that the defendant's rights had not been respected.

Two sets of proceedings were then pending - one before the court where the defendant had its head office, the other before the court where the International Chamber of Commerce had its headquarters. These proceedings could have lasted several years, since they were themselves subject to appeal before the national courts. In these circumstances, and after several years of litigation, the parties agreed to compromise in order to avoid any further litigation, the plaintiff waiving a not inconsiderable part of the damages which had been provided for in the arbitral award.

This example shows that recourse to the courts, whether municipal or international, does not make it possible in practice to resolve difficulties which may arise during the period of the contract. They are therefore generally resolved by amicable discussions or under the auspices of a technical institution, whose intervention (as there has been occasion to state) may be provided for in the agreement, in a consultative and non-judicial capacity.

Thus, without being too pessimistic, there are grounds for thinking that recourse to the courts cannot generally resolve international disputes arising in the course of contracts because of the inevitable delays involved, which are themselves connected with the difficulty of the problems posed.

Nevertheless, after a contract has been broken it is still, of course, the only recourse for an injured party which wishes to have its partner's attitude penalized by the award of damages.

IV. CONCLUSION

The Swiss, who are generally regarded as sound in economic and industrial matters, have a definition of subcontracting which could provide the basis for a conclusion.

They call it "trafic de perfectionnement".

At the world-wide level, this is a highly promising term, since it covers both the development of trade and qualitative improvement.

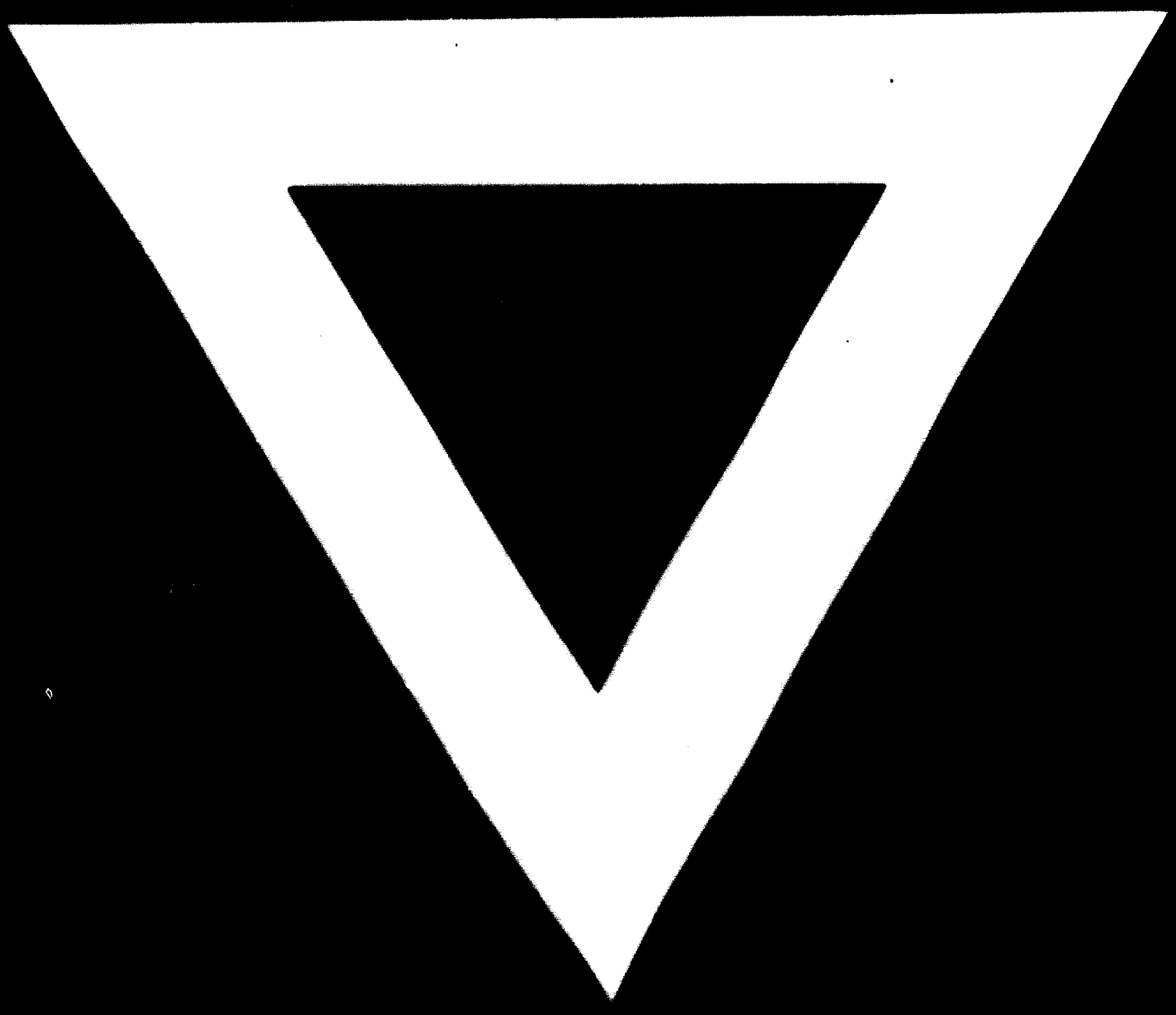
In order for international subcontracting, in whatever form, to be established and to develop, its ethical system must be respected, since it represents a form of international solidarity from which both prime manufacturer and subcontractor can benefit.

It is, however, essential that in the initial stage the developing countries should propose objectives which are not too ambitious, so that their hopes are not dashed. To anticipate the establishment of large automobile component factories within a period of a few years even when the industrial infrastructure is lacking, or to contemplate the introduction of computers in small repair shops, is to disregard reality and to set unattainable targets. Economic expansion must take place in stages in accordance with a certain progression; in the long term the desire to take short cuts is likely to be costly and ineffectual.

The industrialized countries must realize that a broader international distribution of the means of production is not merely a way in which, in the short and medium term, they can keep or win particular markets, but also, in the longer term, a factor in increasing international trade and, consequently, international prosperity, through the ties thus established.

Indeed, rather than import labour, as is very generally the case with the industrialized countries, it now seems much wiser to export work to the places where the labour already exists. Thus subcontracting appears to be the solution entailing least economic and social problems, as compared with actual movements of population involved in excessive industrial centralization, which, by the social shocks which they generate, can only lead to social and political disturbances.

Thus international subcontracting, besides the human solidarity which it can reflect, appears as an undeniable factor making for equilibrium and world peace.



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