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UNCTAD/SDTE/BFB/2

UNITED NATIONS PUBLICATION

Sales No. E.99.II.D.6

ISBN 92-1-112446-8

EXECUTIVE SUMMARY

This report focuses on the legal framework underlying export-import transactions and examines the risks inherent in international trade and the means by which they can be contained. It reviews the most frequent legal problems that arise from the sale of goods when the seller and the buyer are based in different countries.

After the provisions governing the international sales of goods have been introduced, the nature and functions of international commercial terms, or "Incoterms", are discussed. These are internationally standardized definitions setting out the rights and responsibilities of the exporter and the importer regarding the arrangements and payment for the delivery of goods in international transactions. The report then describes the different ways of ensuring that the main contractual obligations under the sale transaction are respected and, in particular, that the promised goods and services are delivered by the seller and the agreed payment is made by the buyer. The principal instruments to secure payment (documentary credits and documentary collections) and performance of the contract (bank guarantees) are therefore described.

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ACKNOWLEDGEMENTS

This report has been prepared by Carlos Moreno, Legal Officer, Cross-Sectoral Legal Unit, Services Development and Trade Efficiency Division, UNCTAD, with substantive inputs from Mahin Faghfouri, Head of the Cross-Sectoral Legal Unit. The UNCTAD secretariat wishes to thank Daniel Devahive, Trade Finance Advisor from Warburg Dillon Read, UBS AG, Geneva, for taking time to read and provide valuable comments on the draft.

INTRODUCTION

1. A typical trade transaction starts with a contract of sale. A seller and a buyer agree a price for a specified quantity and type of goods to be purchased under specified terms and conditions. From the buyer's point of view the legal objective of such a contract is to obtain ownership of the goods, and from the seller's to receive the price. Thus the essence of the contract is the transfer of property in goods for financial consideration.[1]

2. Like any other contract, a contract of sale depends on an agreement—between the seller and the buyer—which is usually shown by the acceptance of an offer.[2] The contract of sale of goods is characterized in a majority of countries by the principle of "freedom of contract": the parties are free to fix the terms and conditions of the contract of sale—what prices will be charged, how payment will be handled, who will bear which costs of delivery, who will support which risks—subject to the general principles of law and to domestic legislation governing unfair contract terms.

3. The contract of sale has been characterized as the "master" contract[3] since the series of contractual arrangements which follow—as regards transport, insurance and payment—should accord with its provisions. Thus to avoid unwanted disputes and litigation it is essential that the contract of sale is carefully drafted and that specific reference is made to existing trade terms, like the current Incoterms (see chapter II), when stipulating the delivery point and the allocation of rights and responsibilities between the buyer and the seller. Moreover, if payment is to be by letter of credit (see chapter III), the requirements under the credit need to be clearly spelt out.

4. International sales of goods differ from domestic sales in a number of ways: they generally involve long distances—during which the goods are in the custody of the carrier—the risks involved in such transit are greater, and the transaction is normally irreversible, in that the physical return of the goods to the seller is in practice unlikely to be a realistic option. Furthermore, because of its nature, the transaction might be subject to a number of different jurisdictions with diverse legal systems. To cope with these problems, the business community has developed a number of standard contracts[4] and rules which cater for the peculiar needs of international commerce.[5]

5. It is the purpose of this report to familiarize readers with some of the most important tools used in international trade to:

(*a*) Allocate the rights and responsibilities of exporters and importers regarding the arrangements and payment for the delivery of the goods (chapter II);

(*b*) Secure the payment by the buyer of the merchandises contracted (chapter III);

(*c*) Protect the buyer against the non-performance of the contractual obligations by the seller (chapter IV).

6. The information provided in this report is not easily accessible to many developing countries and countries with economies in transition. It is believed that awareness of the legal aspects involved in international transactions will assist these countries in conducting international trade more efficiently. Other important issues such as transport and insurance will be dealt with in the second part of this report by the UNCTAD secretariat.

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[1] An exchange of goods is not therefore a contract for the sale of goods but a barter. Likewise a gift for no consideration is not a contract of sale. See P. Sellman, *Law of International Trade*, 7th ed., IILT Publications, 1996, p. 2, London.

[2] The rules as regards the making and communication of offer and acceptance and the revocation and termination of offers are common to all contracts, and may be found in general works on the law of contracts. See, for example, Benjamin, *The Sale of Goods*, Sweet and Maxwell, 1981, p. 22, London.

[3] G. Jiménez, *ICC guide to export-import basics*, Paris, ICC Publication No. 543, 1997, p. 34.

[4] One of the most recent standard contracts is the ICC Model International Sale Contract (1997 edition) for the sale of manufactured goods intended for resale.

[5] C. Debattista, *Sale of Goods Carried by Sea*, Butterworths, 1990, p. 1, London.

Chapter I

INTERNATIONAL SALE OF GOODS

7. Contracts of sale are governed by either national law—the law of the domicile of the seller or the buyer—or by an international treaty, the United Nations Convention on Contracts for the International Sale of Goods (CCISG—described below). Since the CCISG and most national laws are based on the customs of the business community (the *lex mercatoria*[6]) it is not surprising that they exhibit a great degree of similarity. It is precisely for this reason that we will briefly review the main provisions of the Convention.[7]

A. International regulation of the sale of goods

8. Preparation of a uniform law for the international sale of goods began in 1930 at the International Institute for the Unification of Private Law (UNIDROIT) in Rome. It was felt at the time that it would be of great value to the international business community to unify the law relating to international sales, to avoid providing different answers to questions such as when an offer or acceptance becomes effective, when possession, property or risk in the goods sold passes, what the rights of a buyer are when goods not conforming to the contract are tendered, and similar questions.[8] After a long interruption in the work as a result of the Second World War, a draft was finally submitted to a diplomatic conference in The Hague in 1964, which adopted two conventions, the Convention relating to a Uniform Law on the International Sale of Goods and the Convention relating to a Uniform Law on the Formation of Contracts for the International Sale of Goods.

9. Almost immediately upon the adoption of the two conventions, there was widespread criticism of their provisions as reflecting primarily the legal traditions of continental western Europe. One of the first tasks undertaken by the United Nations Commission on International Trade Law (UNCITRAL) upon its establishment in 1968 was to study the two conventions to ascertain which modifications might render them capable of wider acceptance by countries of different legal, social and economic systems. The result of this study was the adoption by diplomatic conference on 11 April 1980 of the United Nations Convention on Contracts for the International Sale of Goods,[9] which combines the subject matter of the two prior conventions.[10]

B. Application of the United Nations Convention on Contracts for the International Sale of Goods

10. Six forms of sale are excluded from the Convention according to article 2, the so-called "consumer contract" (goods bought for personal, family or household use), unless the seller at any time before, or at the time of, the conclusion of the contact neither knew, nor ought to have known, that the contract was a consumer contract. Also excluded are sales by auction and on execution or otherwise by authority of law. The nature of the goods is the basis for three further exclusions: the sale of securities, the sale of ships and aircraft, and the sale of electricity.[11]

11. Article 1 (1) provides for the Convention to apply to contracts of sales of goods between parties whose places of business are in different States when either both of those States are contracting States or the rules of private international law lead to the law of a contracting State. Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be

[6] Among the most authoritative definitions of the *lex mercatoria* are the following: "A set of general principles, and customary rules spontaneously referred to or elaborated in the framework of international trade, without reference to a particular system of law" (B. Goldman, *Contemporary Problems in International Arbitration*, 1983, p. 116); "A single autonomous body of law created by the international business community", (B. M. Cremades and S. L. Plehn, "The New Lex Mercatoria and the Harmonization of the Laws of International Commercial Transactions", *1984, Boston University, International Law Journal*, p. 324). See also Lord Justice Mustill, *The New Lex Mercatoria: The First Twenty-five Years*, Liber Amicorum for the Rt. Hon. Lord Wilberforce, edited by M. Bos and I. Brownlie, Oxford, Clarendon Press, 1987, pp. 149-183.

[7] Cf. footnote 4 above. Failing contrary agreement between the parties, the ICC Model International Sale Contract subjects the transaction to the CCISG, which, for ease of reference, is appended to the model contract as annex I. By means of this incorporation of the CCISG into the model contract, the Convention will apply whether or not the countries of the seller and buyer have ratified the Convention.

[8] C. M. Schmitthoff, *The Law and Practice of International Trade* (9th ed.), Stevens and Sons, 1990, p. 240, London.

[9] The CCISG came into force on 1 January 1988. As at 1 January 1998 the Convention applied in 51 States in different parts of the world and with different economic and legal systems. According to the "Shipping, Transport, Marine Insurance and International Trade Newsletter" of Dibb Lupton Alsop, (March 1998), the States which have adopted the Convention to date are responsible for more than 60 per cent of the total volume of worldwide trade.

[10] See explanatory note by the UNCITRAL secretariat on the United Nations Convention on Contracts for the International Sale of Goods (http://www.un.org@UNCITRAL).

[11] H. van Houtte, *The Law of International Trade*, London, Sweet and Maxwell, 1995, p. 126.

taken into consideration in determining the application of the Convention.

12. According to article 6, the parties may exclude the application of the CCISG or derogate or vary its effect. Parties may also negotiate different clauses in their contract. Moreover, usages which are customary between the parties and any practices which have developed in their relationship take precedence over the rules of the CCISG.[12] Even usages which reasonable people would normally consider to be part of their contract take precedence over the provisions of the Convention.[13]

13. Parties may furthermore agree that the CCISG shall only apply in part and that they will derogate from some other CCISG provisions or alter their legal effect. The basic principle of the Convention is that, subject to one exception, the parties should be free to exclude its terms in whole or in part (article 6). The exception relates to the requirement of writing. The Convention provides that a contract does not have to be concluded, evidenced or varied in writing (article 12).[14] Article 96, however, allows a State whose laws do have such a requirement to make a declaration that this rule is not to apply when any party to the contract has his place of business in that State. In that case, the requirement of writing cannot be excluded.[15]

14. Finally, the CCISG is not applicable to the capacity of the parties, the formal validity of the contract, the transfer of ownership and the legal effects of the contract in respect of third parties.[16]

15. Pursuant to article 92, contracting States may exclude the application of part II (formation of an international contract of sale) or part III (substantive rules).[17]

C. Formation of the contract

16. Part II of the CCISG defines how and when an international contract of sale comes into existence. Thus, in accordance with article 23: "A contract is concluded at the moment when an acceptance of an offer becomes effective in accordance with the provisions of this Convention".

[12] When the seller and the buyer have agreed on a trade term, such as free on board (FOB) or cost, insurance and freight (CIF), the regulation intended by that term takes precedence over the provisions of the Convention. Further, the Convention does not prevent the parties from agreeing on a uniform interpretation of the trade terms by embodying into their contract Incoterms or a similar text. See C. Schmitthoff, op. cit., pp. 245-246.

[13] The standard contracts of the Federation of Oils, Seeds and Fats Associations (FOSFA) and the Grain and Feed Trade Association (GAFTA) include the following clause: "The following shall not apply to this contract: (*a*) the uniform law on sales (. . .); (*b*) the United Nations Convention on Contracts for the International Sale of Goods (. . .)". (Van Houtte, op. cit., p. 127.)

[14] To warn traders of the dangers of contracts based on a "handshake" or a "gentlemen's agreement" the following humorous definition is provided of a gentlemen's agreement: "An unwritten agreement, not a contract, between two parties—neither of which may be a gentleman—under which each party believes the other side is fully bound, while its own performance is strictly optional" (Jiménez, op. cit., p. 33).

[15] Clifford Chance, "The UN Convention on Contracts for the International Sale of Goods", *Maritime Review*, October 1991, No. 8, p. 18.

[16] Van Houtte, op. cit., pp. 127-128.

[17] Ibid., p. 128.

1. *Offer*

17. An "offer" is a statement intended to result in a binding contract if duly accepted by the offeree. It is defined in the Convention as: "a proposal for concluding a contract addressed to one or more specific persons . . . if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance. A proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for determining the quantity and the price." (article 14 (1)) Thus the seller should make certain that the essential elements of the contract are clearly stated in the communications exchanged by the parties. The sending of price lists, catalogues and so on are in principle not offers.

18. The offer is effective as soon as it reaches the offeree (article 15 (2)). The offeror may still withdraw his offer if the withdrawal reaches the offeree before or at the same time as the offer (article 15.2). After the offer has reached the offeree, but before the acceptance has been dispatched, the offer may still be revoked, unless it was irrevocable, or could be considered by the offeree to be irrevocable (article 16).

19. An offer, even if it is irrevocable, is terminated when a rejection reaches the offeror (article 17).

2. *Acceptance*

20. An "acceptance" is defined as a statement made by, or other conduct of, the offeree that indicates assent to an offer. Actions of the acceptor, such as dispatch of goods or payment of the price, may indicate an implied acceptance. Silence or inactivity does not in itself amount to acceptance (article 18). Article 19 deals with the so-called "battle of forms" between the offeror and offeree, when there is a discrepancy between the conditions offered and those accepted. The article reads as follows:

> (1) A reply to an offer which purports to be an acceptance but contains additions, limitations or other modifications is a rejection of the offer and constitutes a counter-offer.
>
> (2) However, a reply to an offer which purports to be an acceptance but 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. If he does not so object, the terms of the contract are the terms of the offer with the modifications contained in the acceptance.
>
> (3) Additional or different terms relating, among other things, to the price, payment, quality and quantity of the goods, place and time of delivery, extent of one party's liability to the other or the settlement of disputes are considered to alter the terms of the offer materially.

D. Obligations and remedies of seller and buyer

21. Part III of the CCISG regulates the respective rights and obligations of buyers and sellers. A fundamental breach of contract is defined in the Convention (article 25) as a breach that results in such a detriment to the other

party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result.

1. *Obligations of the seller*

22. The basic obligation of the seller, as set out in article 30, is "to deliver the goods, hand over any documents relating to them and transfer the property in the goods, as required by the contract and this convention". In general, the seller must deliver goods that are of the quantity, quality and description required by the contract and that are contained or packaged in the manner agreed.

23. The Convention provides supplementary rules (in the absence of contractual agreement) as to when, where and how the seller must perform its obligations. One set of rules of particular importance involves the seller's obligation to deliver goods that are free from any right or claim of a third party, including rights based on industrial property or other intellectual property.

24. In connection with the seller's obligations in regard to the quality of the goods, the Convention contains provisions on the buyer's obligation to inspect the goods. He must give notice of any lack of their conformity with the contract within a reasonable time after he has discovered it or ought to have discovered it, and at the latest two years from the date on which the goods were actually handed over to the buyer, unless this time-limit is inconsistent with a contractual period of guarantee (article 39).[18]

2. *Remedies available to the buyer*

25. If the seller fails to perform any of his obligations the buyer may, depending on the circumstances, resort to the following remedies:[19]

(a) *Request for specific performance*: as provided for in article 46, the buyer may require performance by the seller of his obligations or, if the goods do not conform with the contract, the buyer may require delivery of substitute goods (but only if the lack of conformity constitutes a fundamental breach of contract);

(b) *Time extension and right to cure*: the buyer may fix an additional period of time of reasonable length for performance by the seller of his obligations. The buyer may not, during that period, resort to any remedy for breach of contract. However, the buyer is not deprived thereby of any right he may have to claim damages for delay in performance (article 47);

(c) *Avoidance of the contract*: as provided for in article 49, the buyer may declare the contract avoided: (*a*) if the failure by the seller to perform any of his obligations under the contract amounts to a fundamental breach of contract, or (*b*) in case of non-delivery of the goods;

(d) *Reduction of the price*: as provided for in article 50, if the goods do not conform with the contract and whether or not the price has already been paid, the buyer may reduce the price in the same proportion as the value that the goods actually delivered had at the time of the delivery bears to the value that conforming goods would have had at that time.[20]

3. *Obligations of the buyer*

26. The basic obligation of the buyer is (*a*) to pay the price for the goods and (*b*) take delivery of them as required by the contract (article 53).

(*a*) The obligation to pay covers three elements:[21]

(i) *The determination of the price*: although in principle the price is determined in the contract, in the absence of the same, the parties are considered to have made an implied reference to the price generally charged at the time of conclusion of the contract for such goods sold under comparable circumstances in the trade concerned (article 55);

(ii) *The place of payment*: the price must be paid at the seller's place of business or if the payment is to be made against the handing over of the goods or of documents, at the place where the handing over takes place (article 57);

(iii) *The moment of payment*: in the absence of an agreed time for payment the buyer must pay the price at the moment the seller places either the goods or documents controlling their disposition at the buyer's disposal (article 58 (1)). If the contract involves the carriage of goods, the seller may dispatch the goods on terms whereby the goods, or documents controlling their disposition, will not be handed over to the buyer except against payment of the price (article 58 (2)) unless the contract states otherwise the buyer is not bound to pay the price until he has had the opportunity to examine the goods (article 58 (3)).

(*b*) *Taking delivery*: article 60, specifically provides that the buyer's obligation to take delivery consists in (*a*) doing all the acts which could reasonably be expected of him in order to enable the seller to make delivery, and (*b*) taking over the goods. If the buyer does not take delivery he breaches the contract, which may make him liable for any damage to the goods.

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[18] See explanatory note by the UNCITRAL secretariat on the United Nations Convention on Contracts for the International Sale of Goods, op. cit., p. 57.

[19] By exercising his right to other remedies, the buyer is not deprived of any right he may have to claim damages (article 45 (2)). *The whole thrust of the Convention is on preserving the contract, and not permitting one party or the other to set the contract aside for a relatively minor breach.* This is achieved by disregarding the common law distinction between conditions and warranties. The right of one party or the other to avoid the contract depends particularly upon there having been a fundamental breach. See Clifford Chance, op. cit., p. 20.

[20] This remedy is new to common law. Its advantage is said to be that it enables the buyer to resolve his problem without the need to resort to a court. In many cases, however, this will not be practicable. If payment is made against an irrevocable letter of credit, it will be impossible to reduce the price before payment. Payment will have to be made under protest and reclaimed later (ibid., p. 21).

[21] See Van Houtte, op. cit., pp. 141-142.

4. *Remedies available to the seller*

27. The general pattern of remedies is the same as those available to the buyer: he may require the performance of an obligation, declare the contract avoided and claim damages.[22]

(a) *Request for specific performance*: pursuant to article 62, the seller may require the buyer to pay the price, take delivery or perform his other obligations, unless the seller has resorted to a remedy which is inconsistent with this requirement. The seller may allow the buyer an additional period of time of reasonable length for performance by the buyer of his obligations (article 63 (1)).

(b) *Avoidance of the contract*: the seller may declare the contract avoided (article 64) (*a*) if the failure by the buyer to perform any of his obligations amounts to a fundamental breach of contract, or (*b*) if the buyer does not, within the additional period of time fixed by the seller perform his obligation to pay the price or take delivery of the goods, or if he declares that he will not do so within the period so fixed.

E. Passing of risk

28. A question of risk will arise when the goods which have been agreed to be sold are lost, damaged, destroyed or deteriorated and it is necessary to decide whether the seller or the buyer shall bear the loss.[23]

29. Pursuant to article 66 of the Convention:

> Loss of or damage to the goods after the risk has passed to the buyer does not discharge him from his obligation to pay the price, unless the loss or damage is due to an act or omission of the seller.

30. Parties may stipulate a specific clause for the passing of risk in the contract or they may include it implicitly by referring to an Incoterm. If nothing has been agreed, the supplementary rules of the Convention will apply.[24]

31. The general rule under the Convention is that except for contracts of sales involving carriage the risk passes to the buyer upon delivery when he takes over the goods or, if he does not do so in due time, from the time when the goods are placed at his disposal and he commits a breach of contract by failing to take delivery. However, if the buyer is bound to take over the goods at a place other than the place of business of the seller, the risk passes when delivery is due and the buyer is aware of the fact that the goods are placed at his disposal at that place (article 69 (2)). If the contract relates to goods not then identified the goods are considered not to be placed at the disposal of the buyer until they are clearly identified to the contract (article 69 (3)). For a contract of sale involving carriage the following rules apply (articles 67 and 68):

> (1) If the contract of sale involves carriage of the goods and the seller is not bound to hand them over at a particular place, the risk passes to the buyer when the goods are handed over to the first carrier for transmission to the buyer in accordance with the contract of sale. If the seller is bound to hand the goods over to a carrier at a particular place, the risk does not pass to the buyer until the goods are handed over to the carrier at that place. The fact that the seller is authorized to retain documents controlling the disposition of the goods does not affect the passage of the risk.
>
> (2) Nevertheless, the risk does not pass to the buyer until the goods are clearly identified to the contract, whether by markings on the goods, by shipping documents, by notice given to the buyer or otherwise.
>
> The risk in respect of goods sold in transit passes to the buyer from the time of the conclusion of the contract. However, if the circumstances so indicate, the risk is assumed by the buyer from the time the goods were handed over to the carrier who issued the documents embodying the contract of carriage. Nevertheless, if at the time of the conclusion of the contract of sale the seller knew or ought to have known that the goods had been lost or damaged and did not disclose this to the buyer, the loss or damage is at the risk of the seller.

F. Common provisions for seller and buyer

1. *Anticipatory breach*

32. If, after concluding the contract of sale, it appears that a party will be unable to perform a substantial part of his obligations, the other party may:

(a) *Suspend the performance*: a party may suspend the performance of his obligations if, after the conclusion of the contract, it becomes apparent that the other party will not perform a substantial part of his obligations as a result of (i) a serious deficiency in his ability to perform or in his creditworthiness, or (ii) his conduct in preparing to perform or in performing the contract (article 71). A party suspending performance, whether before or after dispatch of the goods, must immediately give notice of the suspension to the other party and must continue with performance if the other party provides adequate assurance of his performance.

(b) *Avoid the contract*: if prior to the date for performance of the contract it is clear that one of the parties will commit a fundamental breach of contract, the other party may declare the contract avoided. If time allows, the party intending to declare the contract avoided must give reasonable notice to the other party in order to permit him to provide adequate assurance of his performance (articles 72 and 73).

2. *Damages*

33. Damages are due when there is:

(*a*) a breach of contract;

[22] Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. See articles 74 to 77 of the CCISG and footnote 19, above.

[23] As a general rule the risk of the loss is, prima facie, in the person in whom the property is "res peri domino". (See Benjamin, op. cit., p. 402).

[24] Van Houtte, op. cit., p. 144.

(*b*) a loss suffered by the other party; and

(*c*) a causal link between the breach of the contract and the loss.[25]

34. Damages for breach of contract include the loss of profit. Such damages may not exceed the loss which the party in breach foresaw, or should have foreseen, at the time of the conclusion of the contract (article 74). The party claiming damages must take all reasonable measures to mitigate the loss (article 77).

3. *The exemption of* force majeure

35. A party is not liable for failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control. The impediment should be unforeseeable at the time of the conclusion of the contract (article 79 (1)). The exemption is only temporary: it only applies during the time the impediment exists (article 79 (3)).

[25] Van Houtte, op. cit., p. 146.

4. *Preservation of goods*

36. The Convention imposes on both parties the duty to preserve any goods in their possession belonging to the other party. Such a duty is of great importance in an international sale of goods where the other party is from a foreign country and may not have agents in the country where the goods are located. Under certain circumstances the party in possession of the goods may sell them. A party selling the goods has the right to retain out of the proceeds of sale an amount equal to the reasonable expenses of preserving the goods and of selling them and must account to the other party for the balance.[26]

[26] See explanatory note by the UNCITRAL secretariat of the United Nations Convention on Contracts for the International Sale of Goods, op. cit., p. 60.

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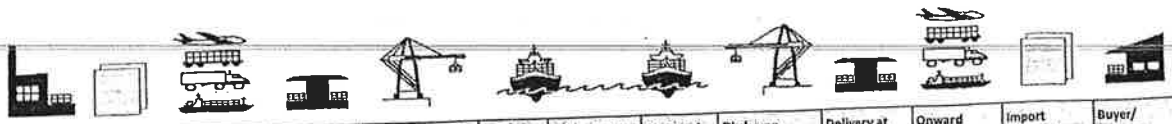
AN ILLUSTRATED GUIDE TO

INCOTERMS 2010 Rules



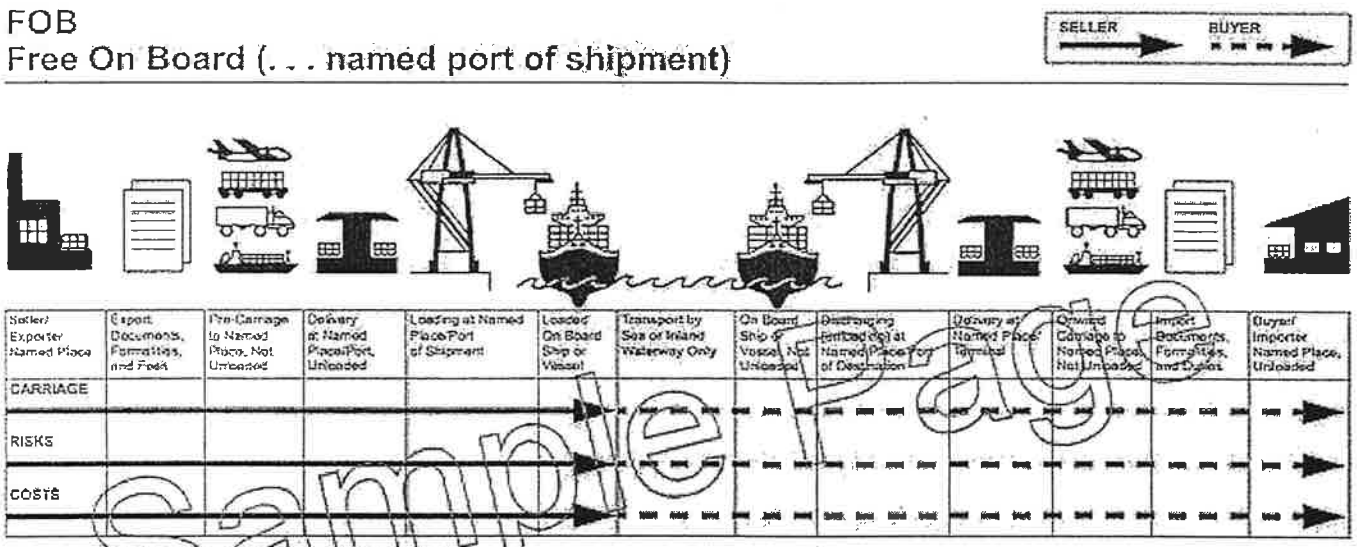
		Seller/ Exporter Not Loaded	Export Formalities and Fees	Pre-Carriage Not Unloaded	Delivery at Named Place Unloaded	Ready for Loading Alongside Ship or Vessel	Loaded On Board Ship	Main Carriage by Air, Road, Rail, or Ocean	On Board Ship or Vessel	Discharge at Port of Arrival	Delivery at Terminal Unloaded	Onward Carriage Not Unloaded	Import Formalities and Duties	Buyer/ Importer Unloaded
Rules for Shipment by Air, Road, Rail, Sea, or Multimodal														
EXW EX Works (...named place of delivery)	Carriage	Loading and carriage of the goods from the "named place of delivery" are arranged by the BUYER												
	Risks	Risk transfers from SELLER to BUYER when the goods are made available to BUYER at SELLER's "named place of delivery," not loaded												
	Costs	Costs transfer from SELLER to BUYER when the goods are made available to BUYER at SELLER's "named place of delivery," not loaded												
FCA Free Carrier (...named place of delivery)	Carriage	Carriage is arranged by the BUYER or by the SELLER on behalf of the BUYER												
	Risks	Risk transfers from the SELLER to the BUYER when the goods have been delivered to the CARRIER at the "named place of delivery"												
	Costs	Costs transfer from the SELLER to the BUYER when the goods have been delivered to the CARRIER at the "named place of delivery"												
CPT Carriage Paid To (...named place of destination)	Carriage	Carriage of the goods to the "named place of destination" is arranged by the SELLER												
	Risks	Risk transfers from the SELLER to the BUYER when the goods have been delivered to the (first) CARRIER												
	Costs	Costs transfer from the SELLER to the BUYER at the "named place of destination"												
CIP Carriage and Insurance Paid To (...named place of destination)	Carriage	Carriage of the goods and insurance to the "named place of destination" are arranged by the SELLER												
	Risks	Risk transfers from the SELLER to the BUYER when the goods have been delivered to the (first) CARRIER												
	Costs	Costs transfer from the SELLER to the BUYER at the "named place of destination"												
DAT Delivered At Terminal (...named terminal at port or place of destination)	Carriage	Carriage of the goods to the "named terminal at port or place of destination," unloaded, is arranged by the SELLER												
	Risks	Risk transfers from the SELLER to the BUYER when the goods are made available to the BUYER at the "named terminal at port or place of destination," unloaded												
	Costs	Costs transfer from the SELLER to the BUYER when the goods are made available to the BUYER at the "named terminal at port or place of destination," unloaded												
DAP Delivered At Place (...named place of destination)	Carriage	Carriage of the goods to the "named place of destination," ready for unloading, is arranged by the SELLER												
	Risks	Risk transfers from the SELLER to the BUYER when the goods are made available, ready for unloading at the "named place of destination"												
	Costs	Costs transfers from the SELLER to the BUYER when the goods are made available, ready for unloading at the "named place of destination"												
DDP Delivered Duty Paid (...named place of destination)	Carriage	Carriage of the goods to the "named place of destination," ready for unloading, is arranged by the SELLER												
	Risks	Risk transfers from the SELLER to the BUYER when the goods are made available ready for unloading at the "named place of destination"												
	Costs	Costs transfer from the SELLER to the BUYER when the goods are made available ready for unloading, cleared for import, at the "named place of destination"												
Rules for Shipment by Sea and Inland Waterway Only														
FAS Free Alongside Ship (...named port of shipment)	Carriage	Pre-carriage of the goods is arranged by the SELLER					Main carriage of the goods is arranged by the BUYER							
	Risks	Risk transfers from the SELLER					to the BUYER when the goods have been placed alongside the ship at the "named port of shipment"							
	Costs	Costs transfer from the SELLER					to the BUYER when the goods have been placed alongside the ship at the "named port of shipment"							
FOB Free On Board (...named port of shipment)	Carriage	Pre-carriage of the goods is arranged by the SELLER					Main carriage of the goods is arranged by the BUYER							
	Risks	Risk transfers from the SELLER to the BUYER					when the goods are loaded on board the ship at the "named port of shipment"							
	Costs	Costs transfer from the SELLER to the BUYER					when the goods are loaded on board the ship at the "named port of shipment"							
CFR Cost and Freight (...named port of destination)	Carriage	Carriage of the goods to the "named port of destination" is arranged by the SELLER						Onward carriage is arranged by the BUYER						
	Risks	Risk transfers from the SELLER to the BUYER when the goods are loaded					on board the ship at the "named port of shipment" (not destination)							
	Costs	Costs transfer from the SELLER to the BUYER upon delivery of the goods,					not unloaded, at the "named port of destination"							
CIF Cost, Insurance and Freight (...named port of destination)	Carriage	Carriage of the goods and insurance to the "named port of destination" is arranged by the SELLER						Onward carriage is arranged by the BUYER						
	Risks	Risk transfers from the SELLER to the BUYER when the goods are loaded					on board the ship at the "named port of shipment" (not destination)							
	Costs	Costs transfer from the SELLER to the BUYER upon delivery of the goods,					not unloaded, at the "named port of destination"							

Notes on INCOTERMS® 2010 RULES (Entry into force: January 1, 2011)

1. Incoterms® 2010 rules are internationally accepted standard definitions of trade terms (**IN**ternational **CO**mmercial **TERMS**). Incoterms® were developed by the ICC (International Chamber of Commerce), Paris, France, in 1936, and have been regularly revised to reflect changes in transportation and documentation. The current version is Incoterms® 2010 (www.iccwbo.org).
2. Incoterms® 2010 rules are not implied into contracts. Buyers and sellers must specify in their contract that it is subject to Incoterms® 2010.
3. Incoterms® 2010 rules DO a) apply to the sale of goods, b) specify each party's obligations regarding carriage, risks, and costs, and c) establish basic terms of transport and delivery.
4. Incoterms® 2010 rules DO NOT a) apply to contracts for services, b) define contractual rights' other them for delivery, c) specify details of the transfer, transport, and delivery of goods, d) determine how title to goods will transfer, e) protect seller or buyer from risk of loss, f) cover the goods before or after delivery, or g) define remedies for breach of contract.
5. **"Delivery"** in Incoterms® 2010 rules is used to "indicate where the risk of loss or damage to the goods passes from the seller to the buyer."
6. **"Pre-Carriage"** indicates the movement of goods prior to the main carriage of the shipment.
7. **"Onward Carriage"** indicates the movement of goods after the main carriage of the shipment.
8. This guide is for easy reference only. For a comprehensive guide to Incoterms® 2010, refer to the *Dictionary of International Trade, 9th Edition*, by World Trade Press.

* Incoterms is a registered trademark of the ICC (International- Chamber of Commerce) and is used here for informational purposes only. This illustrated guide is independently authored and published and is not sponsored or endorsed by, or affiliated with, the ICC. Incoterms@ 2010 rules full text is available from the ICC (www.iccwbo.org).

FOB
Free On Board (. . . named port of shipment)



FOB, Free On Board (. . . named port of shipment)

In Free On Board, the seller/exporter/manufacturer clears the goods for export and delivers them on board the named vessel at the "named port of shipment."

This is a change from Incoterms 2000, where the seller was responsible only to deliver the goods "past the ship's rail."

With FOB, the seller has the option to deliver the goods on board the vessel, or to "procure goods already so delivered." This is a reference to so-called "string sales," where a single shipment might be resold multiple times during transport, as is common in the commodity trade.

The named place in FOB is a port and therefore the term is used only for ocean or inland waterway transport.

With FOB, the named port of shipment is domestic to the seller.

If the shipment is containerized or to be containerized, common practice is to deliver the shipment to the carrier at a terminal and not on board a ship. In such situations, the FCA term is recommended.

The FOB term is commonly used in the sale of bulk commodity cargo such as oil, grains, and ore.

The key document in FOB transactions is the "On Board Bill of Lading."

The named place in FOB is a port, and therefore the term is used only for ocean or inland waterway transport.

Sellers and buyers often misuse the FOB term. FOB does not mean loading goods onto a truck or train at the seller's place of business. FOB is used only in reference to delivering the goods on board a ship in ocean or inland waterway transport. The FCA term, on the other hand, is applicable to all modes of transport.

Examples

FOB, ABC Shipping Line, Vessel XYZ, Buenos Aires, Argentina

FOB, DEF Shipping Line, Vessel UVW, Gdansk, Poland

Modes of Transport

Air—No
Rail—No
Road—No
Sea—Yes
Inland Waterway—Yes
Multimodal—No

INCOTERMS ® 2012 QUICK REFERENCE GUIDE

	Rules for any mode or modes of Transport							Rules for Sea and Inland Waterway Transport			
	EXW	FCA	CPT	CIP	DAT	DAP	DDP	FAS	FOB	CFR	CIF
	Ex Works	Free Carrier	Carriage Paid To	Carriage & Insurance Paid To	Delivered at Terminal	Delivered at Place	Delivery Duty Paid	Free Alongside Ship	Free on Board	Cost & Freight	Cost, Insurance & Freight
SERVICES	***Who Pays***	***Who Pays***	***Who Pays***	***Who Pays***	***Who Pays***	***Who Pays***	***Who Pays***	***Who Pays***	***Who Pays***	***Who Pays***	***Who Pays***
Export Packing	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller
Marking & Labeling	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller
Block and Brace	1	1	1	1	1	1	1	1	1	1	1
Export Clearance (License, EEI/AES)	Buyer	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller
Freight Forwarder Documentation Fees	Buyer	Buyer	Seller	Seller	Seller	Seller	Seller	Buyer	Buyer	Seller	Seller
Inland Freight to Main Carrier	Buyer	2	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller
Origin Terminal Charges	Buyer	Buyer	Seller	Seller	Seller	Seller	Seller	Buyer	Seller	Seller	Seller
Vessel Loading Charges	Buyer	Buyer	Seller	Seller	Seller	Seller	Seller	Buyer	Seller	Seller	Seller
Ocean Freight / Air Freight	Buyer	Buyer	Seller	Seller	Seller	Seller	Seller	Buyer	Buyer	Seller	Seller
Nominate Export Forwarder	Buyer	Buyer	Seller	Seller	Seller	Seller	Seller	Buyer	Buyer	Seller	Seller
Marine Insurance	3	3	3	Seller	3	3	3	3	3	3	Seller
Unload Main Carrier Charges	Buyer	Buyer	4	4	Seller	Seller	Seller	Buyer	Buyer	4	4
Destination Terminal Charges	Buyer	Buyer	4	4	4	Seller	Seller	Buyer	Buyer	4	4
Nominate On-Carrier	Buyer	Buyer	5	5	5	5	Seller	Buyer	Buyer	Buyer	Buyer
Customs Broker Clearance Fees	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Seller	Buyer	Buyer	Buyer	Buyer
Duty, Customs Fees, Taxes	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Seller	Buyer	Buyer	Buyer	Buyer
Delivery to Buyer Destination	Buyer	Buyer	5	5	5	5	Seller	Buyer	Buyer	Buyer	Buyer
Delivering Carrier Unloading	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer

Notes

1 Incoterms® do not deal with the parties' obligations for stowage within a container and therefore, where relevant, the parties should deal with this in the sales contract.

2 FCA Seller's Facility - Buyer pays inland freight; other FCA qualifiers. Seller arranges and loads pre-carriage carrier and pays inland freight to the "F" delivery place.

3 Incoterms® does not obligate the buyer nor must the seller to insure the goods, therefore this issue be addressed elsewhere in the sales contract.

4 Charges paid by Buyer or Seller depending on Contract of Carriage.

5 Charges paid by Seller if through Bill of Lading or door to door rate to Buyers Destination.

Australian Customs and Border Protection Service

INCOTERMS – QUICK REFERENCE GUIDE

Incoterms are the international rules for the interpretation of trade terms used in international trade, formulated by the International Chamber of Commerce.

EXPORTERS COUNTRY Border of country of export →									← IMPORTERS COUNTRY Border of country of export				
COSTS INCLUDED ↓	**EXW**	**FCA**	**FAS**	**FOB**	**CFR**	**CIF**	**CPT**	**CIP**	**DAF**	**DES**	**DEQ**	**DDU**	**DDP**
Packing costs													
Commercial documents													
Inland delivery to first carrier													
Inland delivery to vessel/aircraft													
Wharfage													
Export customs													
Transport documentation*													
Carriage and freight													
Insurance													
Delivery at destination													
Import customs													

	Costs recommended for sea freight only
*	The cost of obtaining an airway bill or bill of lading should still be included in the Free on Board (FOB) value, as they are an essential element of getting the goods on board.

Reference material can be purchased from the International Chamber of Commerce's website, www.iccbooks.com

Incoterms acronyms

CFR - Cost and freight
CIF - Cost, insurance and freight
CIP - Carriage and insurance paid to
CPT - Carriage paid to
DAF - Delivered at frontier
DDP - Delivered duty paid
DDU - Delivered duty unpaid
DEQ - Delivery ex quay
DES - Delivery ex ship
EXW - Ex works
FAS - Free alongside ship
FCA - Free carrier
FOB - Free on board

Please note: this fact sheet is a general guide only.

For more information on any Customs and Border Protection matter, contact the Customs Information and Support Centre on 1300 363 263 or email information@customs.gov.au or browse the website www.customs.gov.au

PILOT FREIGHT SERVICES

INCOTERMS GUIDE

The purpose of Incoterms 2010 is to provide 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. The scope of Incoterms 2010 is limited to matters relating to the rights and obligations of the parties to the contract of sale with respect to the delivery of goods sold. Incoterms 2010 do NOT apply to the contract of carriage. A brief description of each Incoterm is outlined below:

EX WORKS (EXW)

The seller delivers when it places the goods at the disposal of the buyer at the seller's premises or at another named place (i.e., works, factory, warehouse, etc.). The seller does not need to load the goods on any collecting vehicle, nor does it need to clear the goods for export, where such clearance is applicable. This term represents the MINIMUM OBLIGATION FOR THE SELLER.

FREE CARRIER (FCA)

The seller delivers the goods to the carrier or another person nominated by the buyer at the seller's premises or another named place. The parties are well advised to specify as clearly as possible the point within the named place of delivery, as the risk passes to the buyer at that point. The seller is required to clear the goods for export, where applicable.

FREE ALONGSIDE SHIP (FAS)

The seller delivers when the goods are placed alongside the vessel (e.g., on a quay or a barge) nominated by the buyer at the named port of shipment. The risk of loss of or damage to the goods passes when the goods are alongside the ship, and the buyer bears all costs from that moment onwards.

FREE ON BOARD (FOB)

The seller delivers when the goods on board the vessel nominated by the buyer at the named port of shipment or procures the goods already so delivered. The risk of los of or damage to the goods passes when the goods are on board the vessel, and the buyer bears all costs from that moment onwards.

COST & FREIGHT (CFR)

The seller delivers when the goods on board the vessel or procures the goods already so delivered. The risk of loss of or damage to the goods passes when the goods are on board the vessel. The seller must contract for and pay the costs and freight necessary to bring the goods to the named port of destination.

COST, INSURANCE & FREIGHT (CIF)

The seller delivers when on board the vessel or procures the goods already so delivered. The risk of loss of or damage to the goods passes when the goods are on board the vessel. The seller must contract for and pay the costs and freight necessary to bring the goods to the named port of destination. The seller also contracts for insurance cover against the buyer's risk of loss of or damage to the goods during the carriage.

CARRIAGE PAID TO (CPT)

The seller delivers the goods to the carrier or another person nominated by the seller at an agreed place (if any such place is agreed between the parties) and the seller must contract for and pay the costs of carriage necessary to bring the goods to the named place of destination. CPT requires the seller to clear the goods for export, where applicable.

CARRIAGE & INSURANCE PAID TO (CIP)

The seller delivers the goods to the carrier or another person nominated by the seller at an agreed place (if any such place is agreed between the parties) and that the seller must contract for and pay the costs of carriage necessary to bring the goods to the named place of destination. The seller also contracts for insurance cover against the buyer's risk of loss of or damage to goods during the carriage.

PILOT FREIGHT SERVICES

INCOTERMS GUIDE

DELIVERED AT TERMINAL (DAT)

The seller delivers when the goods once unloaded from the arriving means of transport, are placed at the disposal of the buyer at a named terminal at the named port or place of destination. "Terminal" includes any place, whether covered or not, such as a quay, warehouse, container yard or road, rail or air cargo terminal. The seller bears all risks involved in bringing the goods to and unloading them at the terminal at the named port or place of destination.

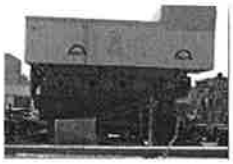
DELIVERED AT PLACE (DAP)

The seller delivers when the goods are placed at the disposal of the buyer on the arriving means of transport ready for unloading at the named place of destination. The seller bears all risks involved in bringing the goods to the named place.

DELIVERED DUTY PAID (DDP)

The seller delivers the goods when the goods are placed at the disposal of the buyer, cleared for import on the arriving means of transport ready for unloading at the named place of destination. The seller bears all costs and risks involved in bringing the goods to the place of destination and has an obligation to clear the goods not only for export but also for import, to pay any duty for both export and import and to carry out all customs formalities.

2



A Guide to the new Incoterms 2010

(effective as of 01/01/2011)

Who pays for what?

- Goods move across international borders because there has been a sale involving:
  - Seller
  - Buyer

- Contract of sale should define the responsibility of both parties relating to:
  - The physical nature of the goods
  - Movement of the consignment

- Buyers and sellers have various options relating to the movement of the goods regarding:
  - The division of costs
  - Defining each parties responsibility and the transfer of risk

What is an Incoterm?

- Sales term incorporated within the contract of sale
- It impacts on the contract of carriage
- Incoterms identify the obligations placed on the parties to the contracts in terms of:
  - Responsibilities relating the costs and the division when shipping the goods
  - Distribution of risks associated with the movement of goods
  - Where these risks transfer to another party

Incoterms 2010

- Published by the International Chamber of Commerce (ICC) to be used in international transactions
- First published in 1936
- Reviewed every 10 years to ensure that they are kept up to date with current trade practices
- Incoterms 2010 will be effective from January 2011

Summary of Main Changes

- Post 1st January 2011 the number of categories has been reduced from four to two.

- These categories cover:
  - Terms for any mode or modes of transport, or:
  - Terms for sea and inland waterway transport

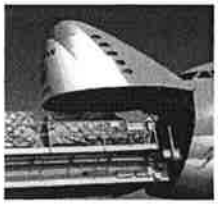
- The aim is to assist Incoterm users in identifying the correct terms for their particular requirements

Reduction in the number of Incoterms

- Current number of 13 Incoterms will be reduced to 11
- The following Incoterms will be removed:
  - DAF
  - DES
  - DEQ
  - DDU
- The following new Incoterms are being introduced:
  - DAT
  - DAP

Terms for any Mode or Modes of Transport

- These consist of the following seven terms:
  - CIP: Carriage and Insurance Paid To
  - CPT: Carriage Paid To
  - DAP: Delivered At Place
  - DAT: Delivered At Terminal
  - DDP: Delivered Duty Paid
  - EXW: Ex Works
  - FCA: Free Carrier
- All of these terms need to specify the port or destination



Terms for Sea and Inland Waterways

- These consist of the following four terms:
  - CFR: Cost and Freight to
  - CIF: Cost, Insurance and Freight to

  } to the named port of destination
  - FAS: Free Alongside Ship
  - FOB: Free On Board

  } to the named port of shipment

Delivered at Terminal (DAT) Definition

- Term may be used for all transport modes
- Seller delivers when the goods, once unloaded from the arriving means of transport, are placed at the disposal of the buyer at a named terminal at the named port or place of destination
- "Terminal" includes quays, warehouses, container yards or road, rail or air terminals
- Both parties should agree the terminal and, if possible, a point within the terminal, at which point the risks will transfer from the seller to the buyer of the goods
- If it is intended that the seller is to bear all the costs and responsibilities from the terminal to another point, DAP or DDP may apply

Delivered at Terminal (DAT) Responsibilities

- The seller is responsible for the costs and risks to bring the goods to the point specified in the contract
- Seller should ensure that their forwarding contract mirrors the contract of sale
- The seller is responsible for the export clearance procedures
- Importer is responsible to:
  - Clear the goods for import
  - Arrange import customs formalities
  - Pay import duty
- If the parties intend the seller to bear the risks and costs of taking the goods from the terminal to another place then the DAP or DAT term should be used

Delivered at Place (DAP) Definition

- Term may be used for all transport modes
- The seller delivers the goods when they are placed at the disposal of the buyer on the arriving means of transport, ready for unloading at the named place of destination
- Parties are advised to specify as clearly as possible the point within the agreed place of destination, because risks transfer at this point from seller to buyer
- If the seller is responsible for clearing the goods, paying duties etc consideration should be given to using the DDP term

Delivered at Place (DAP) Responsibilities

- Seller bears the responsibility and risks to deliver the goods to the named place
- The seller is advised to obtain contracts of carriage that match the contract of sale
- The seller is required to clear the goods for export
- The seller incurs unloading costs at place of destination, unless previously agreed that they are not entitled to recover any such costs
- Importer is responsible for:
  - Effecting customs clearance
  - Paying any customs duties

LIVINGSTON
Trade up

Incoterms® 2010

A practical guide to Incoterms® 2010

When negotiating an international sales contract, you need to pay as much attention to the terms of sale as to the sale price. Minimize confusion by using Incoterms® 2010, the generally accepted series of international trade terms.

Incoterms clarify the responsibilities for delivery of goods between the seller and buyer. This includes the carriage of product, customs clearance and which party carries the risk for the condition of goods at specific times during the transport process. Incoterms are not implied, you must specifically include them in your contract. Further, your contract should clearly refer to the latest revision of Incoterms: Incoterms 2010.

Incoterms are grouped into two classes:

1. Rules for any mode of transport – Includes the terms EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAT (Delivered at Terminal), DAP (Delivered at Place), and DDP (Delivered Duty Paid)
2. Rules for sea and inland waterways only – Includes the terms FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost Insurance and Freight)

This guide is designed to provide a convenient reference for buyers and sellers risks and costs as detailed under each Incoterm.

EXW – Ex Works (...named place)

Seller makes the goods available to the buyer at their door or the end of their dock. Risk and payment of all costs pass from the seller to the buyer at that point. Term is suitable for any mode or combined modes of transport.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – provide at the buyers request, risk and cost, assistance in securing licenses, documentation and authorizations required to export and import the goods • **Carriage** – the seller has no obligation to provide carriage of goods • **Costs** – pay all costs until the goods have been made available to the buyer, often at the seller's door or end of their dock. Costs could include export packaging or inspection certificates (if required)	• **Licenses and Customs Paperwork** – obtain at own risk and costs all export and import licenses, duties, taxes, authorization and documentation • **Risk Transfer** – assumes all risks (loss or damage) from the time the goods have been made available at seller's door • **Costs** – pay all costs from the time the goods have been made available at the seller's door or end of their dock, including any costs resulting from failure to take delivery

The Ex Works term is often used when making an initial quotation for the sale of goods. It represents the cost of the goods without any other costs included.

FCA – Free Carrier (...named place)

Seller is obligated to clear the goods for export, then "deliver" the goods to the named carrier as specified by the buyer. Term is suitable for any mode or combined modes of transport.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage** – seller has no obligation to provide carriage once goods are handed over to the buyer-appointed carrier • **Delivery** – delivery is considered complete once the seller either loads the goods onto the carrier provided by the buyer, or delivers the goods to the buyer-appointed carrier or freight forwarder • **Costs** – pay all costs until goods have been delivered to the buyer-appointed carrier	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer provides for contract of carriage once goods are handed over to carrier • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods are handed over to the carrier • **Costs** – pay any costs for carriage and insurance from the time goods have been delivered to the carrier

"Carrier" has a specific and somewhat expanded meaning. A carrier can be a shipping line, an airline, a trucking firm, or a railway. A carrier can also be an individual or firm who contracts the means of transport, such as a freight forwarder.

FAS – Free Alongside Shipping (...named port of export)

Seller is obligated to clear the goods for export and then arrange for the goods to be delivered alongside the named vessel at the named port of export. Term should be used for ocean and inland waterway shipments only.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage** – seller provides pre-carriage to quay • **Delivery** – delivery is considered complete when seller places goods alongside vessel at the named place and at the stipulated time • **Costs** – seller pays all costs until goods are delivered alongside named vessel	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer provides for contract of carriage from the named port of shipment • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods have been delivered alongside ship • **Costs** – buyer pays all costs for carriage and insurance from the time the goods have been delivered alongside ship

FOB – Free On Board (...named port of export)

Seller is obligated to clear the goods for export and then pay to deliver them "on board" the named vessel at the named port of export. Term should be used for ocean and inland waterway shipments only.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage** – seller provides pre-carriage and vessel loading • **Delivery** – delivery considered complete once seller places goods on board the named vessel at the named port and at stipulated time • **Costs** – seller pays all costs until goods are delivered on board named vessel	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer provides for contract of carriage from the named port of shipment • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods have been loaded onto named vessel • **Costs** – buyer pays any costs for carriage and insurance from the time the goods have been delivered on board the named vessel

FOB is one of the most misused Incoterms. It should be used for sea or inland waterway transport only and not for truck or air shipments. If FOB is currently being used for containerized shipments you should consider the term FCA instead.

CFR – Cost and Freight (...named port of destination)

Seller is responsible for export customs and transport costs to named port of destination. Used only for ocean and inland waterway travel.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage** – seller has obligation to provide carriage of goods to port of destination; however, once goods pass ship's rail at port of shipment, buyer assumes responsibility for loss and damage • **Delivery** – delivery considered complete once product has been loaded at port of shipment • **Costs** – seller pays all transport costs to the port of destination	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer provides for contract of on-carriage from the named port of destination to final destination • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods have passed over ship's rail at port of shipment • **Costs** – pay any additional costs for goods, from the time the goods arrive at the destination port

While the seller may not be legally responsible for the goods once they pass the ship's rail in the port of shipment, he may have an "insurable interest" during the voyage. Prudence may dictate purchase of additional insurance coverage.

CIF – Cost, Insurance and Freight (...named port of destination)

Seller is responsible for export customs, insurance and main carriage costs to named port of destination. Used only for ocean and inland waterway travel.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage and Insurance** – seller has obligation to provide main carriage and insurance to port of destination; insurance policy must allow the buyer to make claim directly from the insurer; however, once goods pass ship's rail at port of shipment, buyer assumes responsibility for loss and damage • **Delivery** – delivery considered complete once product has been loaded at port of shipment • **Costs** – seller pays all transport costs to the port of destination and insurance	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer provides for contract of on-carriage from the named port of destination to final destination • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods have passed over ship's rail at port of shipment • **Costs** – pay any supplemental costs for goods, from the time the goods arrive at the destination port

While the seller may be responsible for sourcing and paying for insurance during the voyage, the buyer may have an "insurable interest" once the goods arrive at the port of destination to their door. Prudence may dictate purchase of additional insurance coverage.

CPT – Carriage Paid To (...named terminal or port at destination)

Seller is responsible for export customs and transportation to destination. Buyer is responsible for all risks of loss or damage once delivered to main carrier. Used for any mode of transportation.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage** – seller has obligation to provide carriage to the named terminal or port at destination • **Delivery** – delivery considered complete once product has been handed over to the main carrier • **Costs** – seller pays all carriage costs until goods arrive and are unloaded at point of destination	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer has no obligation to provide carriage • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods have been delivered to first carrier • **Costs** – pay any additional costs once goods arrive at the agreed destination

While neither the buyer nor the seller have obligation to purchase insurance during the main voyage, both may have an insurable interest. Prudence may dictate the purchase of additional coverage. If multiple carriers are used, risk passes from the seller to the buyer when the goods have been delivered to the first carrier.

CIP – Carriage and Insurance Paid To (...named terminal or port at destination)

Seller is responsible for export customs, insurance and transportation to destination. Buyer is responsible for all risk of loss or damage once delivered to main carrier. Used for any mode of transport.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage and Insurance** – seller has obligation to provide main carriage and insurance to point of destination; insurance policy must allow buyer to make claim directly from the insurer • **Delivery** – delivery considered complete once product has been handed over to the main carrier • **Costs** – seller pays carriage and insurance costs up to named port or terminal at destination	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer has no obligation to provide carriage up to terminal or port at destination • **Risk Transfer** – buyer assumes all risk of loss or damage once the goods have been delivered to the main carrier in the country of origin • **Costs** – buyer will assume any additional costs once the goods arrive at the named terminal or port at destination

DAT – Delivered at Terminal (...named terminal at destination)

Seller is responsible for all costs associated with getting the goods to the terminal at the named destination and unloaded from the arriving means of transport. Can be used for any mode or combined modes of transport.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage** – seller has the obligation to provide carriage and make the goods available to the buyer at the destination terminal, unloaded from the arriving means of transport • **Delivery** – delivery considered complete once product has been unloaded from the arriving means of transport • **Costs** – seller pays all costs up to destination terminal, including any terminals, handling or other ancillary costs	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer has no obligation to seller to provide carriage • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods have been made available at the terminal • **Costs** – buyer is responsible for any costs once the goods have been made available at the terminal at the named destination

DAP – Delivered at Place (...named place of destination)

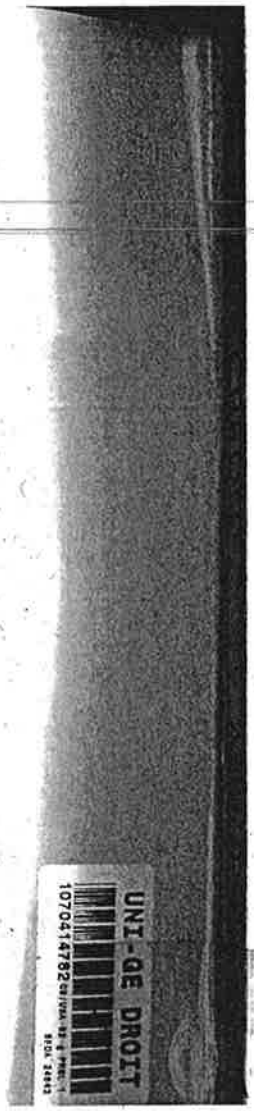
Seller is responsible for delivering the goods to the named place at destination (often the buyer's door), ready to unload from the arriving means of transport. Buyer is responsible for import customs clearance. DAP is a suitable substitute for Delivery Duty Unpaid (DDU), a previous Incoterm that has been eliminated in the Incoterms 2010 version.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export duties, taxes and export formalities • **Carriage** – seller has obligation to provide carriage to named destination • **Delivery** – delivery considered complete once product has arrived at named place of destination, not unloaded • **Costs** – pay all costs until goods have been delivered to the named destination	• **Licenses and Customs Paperwork** – buyer required to perform and pay all costs related to import formalities including duties and taxes • **Carriage** – buyer has no obligation to seller to provide carriage • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods have been made available at named place of destination • **Costs** – pay any costs for goods once they have been made available at the named place of destination

DDP – Delivered Duty Paid (...named port at destination)

Seller is responsible for all costs associated with making goods available to buyer at named place of destination, cleared for import but not unloaded from vehicle. Used for any mode of transport.

Seller's responsibilities (summary)	Buyer's responsibilities (summary)
• **Licenses and Customs Paperwork** – seller obtains at own risk and cost all export and import duties, taxes and customs formalities • **Carriage** – seller has obligation to provide carriage to named destination • **Delivery** – delivery considered complete once product has arrived at named destination, not unloaded from the arriving means of transport • **Costs** – pay all costs until the goods have been delivered to the named destination, often the buyer's door	• **Licenses and Customs Paperwork** – buyer required to provide, at seller's request, risk and assistance in securing licenses, documentation and authorizations required to export and import goods • **Carriage** – buyer has no obligation to seller to provide carriage • **Risk Transfer** – buyer assumes all risk of loss or damage from the time the goods have been made available at named place of destination • **Costs** – pay any costs for the goods once they have been made available at the named place of destination



A PRACTICAL GUIDE TO

Letters of Credit

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CHAPTER ONE

INTRODUCTION TO LETTERS OF CREDIT

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This chapter is intended to provide the reader with a general introduction to and overview of letter of credit law and transactions. A letter of credit is an undertaking to pay, upon the presentation of documents complying with the terms of the letter, the amount called for by the letter. This obligation is undertaken at the request of a customer of the party issuing the letter, for the benefit of a party with whom typically the customer has dealt.

A letter of credit is a commercial specialty that is similar to, but in significant ways different from, contracts or guaranty agreements. The letter of credit is not itself a contract, although contractual undertakings underlie the letter. The parties' obligations are subject to special rules applicable to letter of credit transactions, which rules reach beyond the normal contractual obligations.[1] The letter of credit is not technically a guaranty, and the various suretyship defenses are inapplicable to letter of credit obligations. Yet at its root the issuing bank "guarantees" payment of an obligation.

The letter of credit transaction is basically a three part transaction. There are two contracts and the letter of credit obligation itself. First, there is typically a contract between the customer (who procures the letter of credit) and the beneficiary (who is entitled to draw under the letter) under which the customer owes some obligation to the beneficiary that will or may be satisfied by payment under a letter of credit. Second, there is a contract between the issuer and its customer under which the customer induces the issuer to issue a letter of credit. Typically this contract requires the customer to reimburse the issuer for any payments under the letter of credit.[2] This reimbursement obligation is often secured by property of the customer. Third, the letter of credit obligation flows between the issuer and the beneficiary, obligating the issuer to pay or honor drafts or drawings under the letter of credit upon the presentation of conforming documents. This obligation is not subject to normal contract defenses of the issuer, and is completely independent of the underlying contract between the customer and the beneficiary that led to the issuance of the letter.

Governing Law

The statutory rules governing letters of credit are found in Article 5 of the Uniform Commercial Code (U.C.C.). Letters of credit may also be governed by the Uniform Customs and Practice for Documentary Credits (U.C.P.), promulgated by the International Chamber of Commerce.[3] These statutory customs and rules do not, however, comprehensively treat the topic, and a significant body of case law exists that interprets and supplements these statutory provisions. In general, the courts have looked to common law contract rules to supplement the statutory provisions, but in some cases courts have fashioned a common law for letters of credit.[4]

Although the U.C.C. and the U.C.P. are generally consistent, there are differences in their treatment.[5] When differences arise, it may be difficult to determine which rule applies. Article 5 of the U.C.C. contains a broad scope provision that brings within its terms most mercantile letters of credit.[6] Similarly, the U.C.P. applies "to all documentary credits" and its terms "are binding upon all parties thereto unless otherwise expressly agreed."[7] Thus, either set of rules could be applied.

Some jurisdictions have adopted a nonuniform amendment to Article 5 rendering Article 5 inapplicable to credits that are expressly made subject to the U.C.P.[8] In the remaining jurisdictions, the U.C.P. does not have the force of law and represents an embodiment of current trade usage. To the extent that parties are subject to trade usage, the provision of the U.C.P. could be interpreted as overriding the U.C.C.[9] Of course, in international transactions conflict of law rules must be consulted to determine whether the U.C.C. may apply. Fortunately, most conflicts in the rules can be resolved by proper interpretation of the applicable rules; thus, no serious problems have arisen.[10]

Parties to the Letter of Credit Transaction

Issuer

The issuer is the party, usually but not necessarily a bank, that issues the letter of credit.[11] The issuer undertakes an absolute obligation to pay upon the presentation of proper documents.[12]

Customer

The customer (also known as the account party or applicant) is the party that induces the issuer to issue the letter of credit.[13] Typically, the customer pays a fee to the issuer as consideration for the issuance of the letter of credit. The customer is normally obligated to reimburse the issuer for any payments made under the letter of credit, and the customer often provides collateral to secure the reimbursement obligation. With a commercial letter of credit, the issuer may retain the documents of title as security. A bank that procures the issuance or confirmation of a letter of credit on behalf of a customer of the bank is also a customer.[14]

Beneficiary

The beneficiary is the party entitled to draw or demand payment under the letter of credit.[15] The beneficiary will have to present the required documents when payment is demanded. As we will see, the beneficiary's rights and obligations under the letter of credit are completely independent of the underlying contract between the customer and the beneficiary.

Advising Bank

An advising bank gives notification that a letter of credit has been issued by another bank.[16] The advising bank does not itself undertake any obligation to honor the letter of credit or drafts drawn under the letter. Its obligation is limited to accurately advising the terms of a letter of credit that has been issued.

Confirming Bank

A confirming bank confirms that a letter of credit has been issued by the issuer. The confirming bank becomes directly obligated on the credit to the extent of its confirmation and by confirmation the bank receives the rights and obligations of an issuer. The confirming bank is typically a bank in the beneficiary's locale. This offers the beneficiary a local party from which to seek payment when the issuer is located in a distant jurisdiction.

Typical Letter of Credit Transactions

Commercial Credit

As a typical commercial credit transaction, consider a buyer in Boston who is purchasing goods from a seller in Sicily. The seller could ship the goods to the buyer on credit, but if the buyer failed to pay upon delivery the seller would have to sue the buyer in a distant foreign country and would have the additional risk that the buyer might be judgment proof. Alternatively, the seller could require the buyer to pay prior to shipment, but the buyer might be unwilling to do so. After all, if the buyer prepaid and the seller thereafter breached or repudiated, the buyer would have to go to Sicily to sue the seller, and might face difficulties in collecting any resulting judgment. As a third alternative, the seller could ship the goods C.O.D., requiring the buyer to pay on or prior to delivery against shipment documents. The shipment documents would assure the buyer that upon payment it would receive the goods, and would assure the seller that the goods would not be released until the buyer has paid for them. Nevertheless, if the buyer failed to pay for the goods, the seller would have the burden of redisposing of the goods in a distant place, or of having the goods reshipped to Sicily or elsewhere.

The letter of credit allows the parties to avoid many of these risks. By procuring a letter of credit from a reputable Boston bank, the buyer provides assurance to the seller that upon the presentation of proper documents, the seller will have a right to payment from a very solvent bank, rather than from an unknown and perhaps risky buyer. The choice of documents, including bills of lading, inspection certificates, and other documents, can generally assure the buyer that payment will be made by the bank only if the proper goods have been shipped by the seller.

In issuing the letter of credit, the bank becomes entitled to reimbursement from its customer for any payments that it properly makes. The bank may secure this reimbursement obligation with collateral provided by the customer or by retaining possession of the shipping documents, which would provide it with a security interest in the goods covered by the documents.[17] Of course, the bank will receive a fee for issuing the letter of credit.

Once the Boston bank issues the letter of credit, it can notify the Sicilian seller directly that the letter has been issued, but it is unlikely that the seller will have a telex or other facility to receive the notification. More likely, the parties will elect to have a Sicilian bank notify the seller that a letter has been properly issued, and of the terms of the letter. Thus, the Sicilian bank will become an advising bank, advising the seller of the terms of the letter issued by the Boston bank. By receiving its advice from a local bank, the seller has greater assurance that an enforceable letter of credit was issued by the Boston bank.

Although advice of the credit assures the seller that a letter of credit was issued, if the Boston bank should refuse to pay upon the presentation of proper documents, the seller might still have to litigate in Boston, where the issuer is located. The seller can avoid this inconvenience by requiring that a Sicilian bank serve as a confirming bank. In that case, instead of merely notifying the seller that a letter has been issued, the Sicilian bank would become obligated on the letter as if it were the issuer,[18] and dishonor of a proper demand for payment would give the seller a cause of action against a local Sicilian bank instead of a distant Boston bank. Of course, if the Sicilian bank pays the letter, it will typically be entitled to reimbursement from the Boston bank that issued the letter.[19]

Standby Letter of Credit

As a typical standby letter of credit transaction, consider a contractor that has undertaken the construction of a large office building. The property owner was concerned about the contractor's performance ability, and required the posting of a letter of credit to be drawn upon in the event that the contractor defaulted in its performance. Under the terms of the letter, the owner could draw on the letter, up to $5,000,000, upon the presentation of a draft and a document certifying that the contractor has failed to meet the interim deadlines in the contract. The letter of credit would expire six months after issuance.

If the contractor performs properly, most likely the letter of credit will not be drawn upon and will simply expire according to its terms. If, however, the contractor defaulted on its performance, the owner would present the issuer with a draft and a certification that the contractor failed to comply with the interim deadlines in the contract. Upon presentation of the documents called for by the letter of credit, the issuer would be bound to honor the draft and pay the amount demanded, up to a maximum of $5,000,000, to the owner.

Use of the standby letter of credit assures the owner that a financially secure bank is available to satisfy the damages that may arise as a result of the contractor's default. The requirement of a default certification provides some protection to the contractor against a draw by an owner who is not entitled to payment. Of course, if the owner improperly draws on the letter of credit, the contractor will have to seek recovery from the owner based on a breach of contract theory.[20]

Attributes of Typical Letter of Credit

Payment Against Documents

A letter of credit may envision payment of the customer's contractual obligations, and may be issued pursuant to a contract between a customer and its bank, but the letter of credit obligation is separate from either of those contractual obligations. The terms of the letter are different from the terms of the underlying contract in that a letter of credit cannot require performance as a condition of payment. Instead, in order to be a letter of

credit, the letter must require the presentation of documents as a condition of payment. The documents may, as a practical matter, certify that contract performance has properly occurred; however, the issuer has no independent obligation to determine that in fact such performance has occurred. The issuer need merely determine that the documents presented conform with the requirements of the letter of credit.

In *Transparent Products Corp. v. Paysaver Credit Union*,[21] the court distinguished between a letter of credit and a line of credit. In that case, the credit union issued a letter, denominated a letter of credit, which was addressed to a creditor of the customer and stated simply that "We hereby establish our letter of credit at the request of [the customer] up to the aggregate amount of fifty-thousand dollars ($50,000)." When the creditor sought to draw on the "letter of credit" the credit union objected, claiming that it had no obligation to the creditor.

If the letter was in fact a letter of credit, the issuer would be absolutely liable for payment. The court found, however, that the document was not a letter of credit; therefore the credit union had no liability to the creditor.

The court observed that a letter of credit must specify the terms upon which it is payable. In order to maintain the reliability of the letter of credit, courts will not look beyond the terms of the document to determine the intent of the parties. Yet without any explicit indication of when or under what circumstances this "letter of credit" could be drawn upon, a court would have to examine the unstated intention of the parties. In the court's view, "calling a pumpkin a 'letter of credit' will not make it one", and this document "engaging to do nothing and mentioning no events is simply a stray piece of paper."

Revocable and Irrevocable Credits

A letter of credit may be revocable or irrevocable. If the letter is revocable, the issuer may revoke or modify the letter of credit at any time without notice to or consent of the customer or beneficiary.[22] However, any person authorized to pay or negotiate the original credit is entitled to reimbursement for payment or negotiation that occurred prior to notification of a modification or revocation of the letter of credit.[23] Since a revocable letter of credit can otherwise be revoked or modified at will, the principal legal effect of a revocable letter of credit is with respect to the rights of third parties who pay or negotiate the letter prior to notice of a revocation or modification.

Most letters of credit are irrevocable. Under an irrevocable letter the issuer remains bound according to the terms of the letter. The U.C.P. provides that a letter of credit that does not explicitly state that it is irrevocable is treated as a revocable letter. The U.C.C. does not contain any rule with respect to letters of credit that do not indicate whether or not they are revocable. Since the parties to a letter of credit generally expect an irrevocable letter, it is obviously good practice to explicitly indicate that the letter is irrevocable.

Negotiation Credits

A letter of credit may envision payment, acceptance, or negotiation of drafts drawn under the letter. A payment credit requires the issuer to pay the amount properly demanded. An acceptance credit requires the issuer to accept a draft properly drawn under the letter. Acceptance of the draft makes the issuer primarily liable on the draft obligating the issuer to pay under the terms of the draft.[24]

A negotiation credit authorizes negotiation of drafts drawn under the credit. Normally, if the beneficiary does not present its draft directly to the issuing bank, the beneficiary will present its draft through its own bank by depositing the draft and appropriate documentation for collection. In that case, the collecting bank acts as the beneficiary's agent for collection and the draft must be presented to the issuer prior to the expiration of the letter.

A negotiation credit provides that drafts may be negotiated. Negotiation of the drafts under a negotiation credit typically satisfies the presentment requirements of the letter, triggering the issuer's obligation to honor the drafts. Thus, unlike a payment or acceptance credit, a negotiation credit enables the beneficiary to assure that timely presentment occurs by timing the presentment as of the negotiation of the drafts rather than as of the actual presentment.

Rights and Duties of the Issuer

The issuer is required to examine the documents that are presented for payment or honor and, if they are conforming, to pay or honor the letter of credit.[25] Under the U.C.C., the issuer has three days to decide whether to honor the demand.[26] Failure to act within that period operates as a dishonor. Article 16 of the U.C.P. provides that the issuer has "a reasonable time in which to examine the documents and to determine as above whether to take up or to refuse the documents." Failure to act within that reasonable time precludes the issuer from claiming that the documents are noncomplying.

Under the majority view, if the documents fail to strictly comply with the requirements of the letter of credit, the issuer may dishonor the demand and refuse to pay. This strict compliance standard is an important feature of letter of credit law. The issuer's ability to rely on the strict compliance doctrine relieves the issuer of the need to exercise discretion about whether a nonconformity is or is not material or substantial. Any nonconformity, or certainly any but the most trivial nonconformity, provides a rightful basis for dishonor.[27]

Under the minority view, substantial documentary compliance may be sufficient to deny the issuer a right to dishonor.[28] Although this approach requires the issuer to exercise discretion in determining whether a nonconformity is substantial, and such an exercise may be undesirable as an inefficient use of the issuer's resources, it does have the benefit of preventing "technical" dishonors that might occur when the documents fail to strictly conform to the letter but are not in any serious way deficient.

A third line of cases adopts a bifurcated standard under which the issuing bank may dishonor a demand under a letter of credit based on the strict compliance approach, but may honor a noncomplying demand under a substantial compliance approach. In other words, the bank may rightfully dishonor based on even a minor nonconformity. However, if the bank elects to honor the demand, it will be entitled to reimbursement from its customer as long as the demand substantially complied with the requirements of the letter.[29]

Even those courts applying the clear majority approach requiring strict compliance recognize that the doctrines of waiver and estoppel may operate to protect a beneficiary notwithstanding that the documents presented failed to conform to the requirements of the letter of credit. For example, Article 16 of the U.C.P. requires the issuing bank to give its reason or reasons for dishonoring a demand under a letter of credit. A similar duty may be implied under the U.C.C. Failure to comply with this requirement may be a basis for precluding the issuer from relying on the defects in the documents to justify dishonor.[30] At the very least, such a failure may operate as a waiver or estoppel of the issuer's right when the beneficiary could have corrected the deficiency with prompt notice or when the beneficiary changed its position in reliance on the failure to receive notice.

In any event, typically an issuing bank may honor a demand under a letter of credit even if the documents do not strictly comply; notwithstanding the noncompliance the issuer will likely obtain reimbursement from its customer as long as its honor was in good faith and the nonconformity was not substantial. This result obtains in some jurisdictions under the bifurcated approach to strict compliance discussed above. Even without the bifurcated approach, the agreement between the customer and its bank will typically hold the bank only to a duty of good faith, and relieve the bank of liability for good faith, reasonable actions.

Independence Principle

One of the cornerstones of letter of credit law is the so-called "independence principle." The independence principle holds that the issuer's payment obligation is wholly independent from the underlying transaction that led to the issuance of the letter of credit. Thus, whether or not the beneficiary has properly performed under the underlying contract, and whether or not the beneficiary is contractually entitled to payment, the issuer is legally obligated to pay upon the presentation of documents that conform to the requirements of the letter of credit.

Enjoining Payment of a Letter of Credit—Fraud in Transaction

Notwithstanding the independence principle, a customer may seek to prevent payment when the customer believes that the beneficiary's performance is defective or that the beneficiary is for some reason not entitled to payment. Normally, attempts to prevent payment based on breach of the underlying contract will fail. In most situations, the independence principle prevents the issuer from dishonoring a demand because of a breach of the underlying contract. In addition, although an issuing bank may want to satisfy its customer by following the customer's request that it dishonor a demand, the issuer is typically more concerned with maintaining its reputation as an issuer that honors its letters of credit. Thus, issuers rarely dishonor letters of credit if the documents comply with the terms of the credit.

When the breach of the underlying contract is in the nature of fraud, or where the documents are forged or fraudulent, the customer may be able to obtain an injunction against payment under the letter of credit. This fraud basis for an injunction represents the primary exception to the independence principle.

The seminal case involving the enjoining of payment of a letter of credit is *Sztejn v. J Henry Schroder Banking Corp.*[31] In that case the plaintiff, the customer that had procured the issuance of a letter of credit, sought to enjoin the bank's payment of the letter on the ground that the beneficiary had committed fraud by shipping merchandise that was not "merely inferior in quality" but rather was "worthless rubbish." The court recognized that the independence principle could be overridden when there was "active fraud on the part of the seller." Thus, the court found, if the plaintiff could prove its allegations it would be entitled to an injunction barring payment under the letter.

The *Sztejn* case was codified, and its holding somewhat expanded, in U.C.C. section 5-114(2). That section provides as follows:

> (2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction:
>
> (a) The issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302); and
>
> (b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.

Under section 5-114, then, payment may be enjoined, if demanded by a party other than a holder in due course, when warranties on negotiation or transfer of a negotiable document of title or a certificated security are breached, when documents are forged or fraudulent, or when there is fraud in the transaction. Violation of the warranties and forged or fraudulent documents generally relate to the presentation of false documents. These are relatively straightforward grounds for enjoining payment.

The fraud in the transaction basis is significantly more complex. Clearly the type of fraud justifying an injunction is more than a mere breach of warranty or breach of contract. It is unclear just how serious the breach must be. In the *Sztejn* case, worthless cowhair was shipped instead of the bristles called for by the contract. This was sufficient fraud.

One question that has arisen among the commentators is whether the fraud must be in the letter of credit transaction or whether it may be in the underlying transaction. Some have argued that the fraud must be in the letter of credit transaction, not in the underlying transaction, and justify the *Sztejn* case as one in which fraudulent documents were presented to the issuer.[32] Others view the language and the drafting history of section 5-114(2) as evidencing an intention to include fraud in the underlying transaction.[33] These commentators point out that fraudulent documents are covered by other portions of section 5-114(2) so that the fraud in the transaction language must relate to the underlying transaction. Still other commentators, led by Professor Dolan, argue that the utility of the letter of credit is best served by interpreting narrowly the fraud in the transaction doctrine and applying it only to those cases in which the nature of the fraud and the need for an injunction can be proven in a summary proceeding.[34] Under this view, the need for a speedy resolution and certainty of payment will usually outweigh any perceived need to prevent fraud.

Another question is whether the issuer may dishonor in the absence of a court injunction when the issuer is informed by its customer that fraud has occurred. One leading case has said that the issuer may dishonor without being enjoined. In *Roman Ceramics Corp. v. Peoples National Bank*,[35] the court held that "if the circumstances are such that the honor of the draft could be enjoined, then the bank was within its rights to determine on its own initiative that the draft should not be honored."

In seeking an injunction, the customer must meet the traditional test for the issuance of an injunction. Although the precise standard for the issuance of a preliminary injunction varies among the jurisdictions, courts use generally a test that balances the needs of the movant with those of the party to be enjoined. In general, a movant must show that (1) there is a strong likelihood of success on the merits; (2) the movant will suffer irreparable injury in the absence of an injunction; (3) the potential injury to the movant outweighs the potential harm to the party to be enjoined that will result if an injunction is issued; and (4) the public interest would be served by the issuance of an injunction.[36]

In the Second and Ninth Circuits, the standard for the issuance of a preliminary injunction is somewhat more liberal. The movant must make a clear showing of either (1) probable success on the merits and possible irreparable injury or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly toward the party seeking relief.[37] Although the standard does not explicitly mention the public interest, a court may take into account the public interest in deciding whether the issuance of an injunction is appropriate.[38]

Thus, in seeking an injunction, it is generally not sufficient for the customer to show that there is fraud. The potential harm must be severe and irreparable and outweigh any harm that an injunction would cause to the party to be enjoined. For example, in *KMW International v. Chase Manhattan Bank, N.A.*,[39] one of the many cases in which an Iranian buyer sought to draw on a letter of credit after the underlying sale transaction collapsed in the wake of the Iranian revolution, the seller who had procured the letter sought to enjoin payment. The seller argued that the draw under the letter was fraudulent because contract performance had been frustrated by the supervening political unrest. The Second Circuit Court of Appeals found that the seller had failed to meet the test for the issuance of a preliminary injunction because the seller had failed to show the likelihood of irreparable harm; the seller merely faced a normal business risk of an international transaction which includes the possibility that a seller will be unable to collect from a breaching buyer. Moreover, the seller had failed to show the probability of success on the merits because it had shown no basis for believing that there was fraud in the transaction. According to the court, "insurrection or supervening impossibility are not equivalent to fraud."

In any event, payment may not be denied or enjoined when it is sought by a holder in due course. If the credit is a negotiation credit, then the beneficiary can negotiate a draft to a subsequent holder in due course. A holder in due course is a person who took the draft by negotiation for value, in good faith, and without notice of claims to or defenses against the instrument.[40]

If the credit is not a negotiation credit, then arguably the issuer and its customer have not assumed the risk of subsequent holders in due course. In that case, any collecting bank is an agent of the beneficiary and should not have any greater rights than the beneficiary. In other words, if the credit is not negotiable there should not be a subsequent holder in due course. However, some courts have failed to appreciate this distinction, and it is possible that an assignee of a non-negotiable credit could be treated as a holder in due course, free of the fraud in the transaction defense.

Customer's Reimbursement Obligation

Once the issuing bank pays on a letter of credit, the customer must reimburse the bank for its payment.[41] The issuer may secure this obligation with assets of the customer, or may, by paying the letter of credit, in effect extend unsecured credit to its customer. In a commercial letter of credit, substantial security may be gained by the issuer's retention of the documents of title and other documents that are received from the beneficiary prior to payment on the letter. Possession of documents of title will typically give the issuer a security interest in the goods covered by the documents.[42]

Bankruptcy of the Customer

Bankruptcy of the customer prior to payment of a letter of credit may affect the issuer's ability to obtain reimbursement of amounts paid under the letter of credit. Unless the issuer holds a security interest in the customer's property, the issuer will be a mere general creditor and will share with the other general creditors. Of course, due to the operation of the independence principle, bankruptcy of the customer will not relieve the issuer of its obligation to pay under the letter of credit.

If the issuer took a security interest in the customer's property at the time that the letter was issued, generally the security interest, if properly perfected, will be enforceable in the customer's bankruptcy. The security interest is not avoidable as a preference since it is treated as arising when the letter of credit is issued, and is not a transfer on account of an antecedent debt. Since the letter of credit represents value in exchange for the grant of the security interest, there is generally no fraudulent conveyance problem. Thus, the bank's ability to obtain reimbursement will generally be protected.

However, a question concerning the bank's position has arisen in cases in which the letter of credit has been issued on account of an antecedent debt owed by the customer to the beneficiary of the letter of credit. If the letter was issued on account of an antecedent debt, arguably the grant of the security interest was on account of an antecedent debt because it was granted in order to induce the bank to issue the letter in favor of the beneficiary. In the language of Bankruptcy Code section 547, the security interest may have been granted "for the benefit of" the beneficiary-creditor. In that case, arguably the security interest may be avoided as a preference, with the bank retaining only an unsecured reimbursement claim against its customer. More likely, however, the bankruptcy trustee would be limited to recovering the "preferential" payment from the party for whose benefit the security transfer occurred—the beneficiary under the letter of credit.[43]

Transfer and Assignment

A letter of credit is not normally transferrable unless it is explicitly by its language made transferrable.[44] Although the beneficiary of a letter of credit may assign its right to the proceeds of the letter, the right to actually draw under the letter is normally limited to the beneficiary named by the letter. Thus, while normally drafts drawn under a letter of credit may be

assigned to a third party for collection of the proceeds of the letter, the right to draw drafts under the letter, and to present the appropriate documentation, may not be transferred unless the letter is explicitly transferrable.

The reasons for this distinction seem obvious. The account party who procured the letter of credit very likely expected performance from the named beneficiary. The protection of the account party's expectation of proper performance is dependent on performance by the named beneficiary, not by a third party with whom the account party may have had no dealings and with whom the account party may not be familiar. The risk undertaken by the account party may be increased by a transfer of the letter, and the account party is not required to accept such increased risk. In addition, transfer of the letter of credit places the issuer in the difficult position of determining whether substitute performance tendered by a transferee constitutes strict compliance with the terms of the letter. As one commentator has stated, "These cases [permitting transfer of a letter of credit] force the issuer to decide whether concerns of international law, insurance liquidation law and bankruptcy law excuse strict compliance with the terms of the credit. The burden of that inquiry is far greater than the burden the strict-compliance rule imposes on the issuer. Under the rule of these cases, issuers must invoke legal concepts and may have to litigate; under the strict compliance rule, the issuer need only determine whether the documents comply on their face with the terms of the credit."[45]

In general, courts have respected this rule of nontransferability of letters of credit. However, exceptions have developed when transfer of the letter occurs by operation of law[46] or when international law would recognize the transfer of rights.[47] In *Federal Deposit Insurance Corp. v. Bank of Boulder*,[48] the court recognized still another exception to the general rule of nontransferability when it permitted the FDIC, acting in its corporate capacity, to enforce a letter of credit issued to a failed bank.

The right to proceeds under the letter of credit may be assigned without assigning the right to actually draw.[49] The assignment typically occurs through the beneficiary's assignment or negotiation of a draft drawn by the beneficiary, accompanied by the letter of credit.[50] If the credit is not a negotiation credit, presentment to the issuer must be made prior to the expiration date of the letter. If the credit is a negotiation credit, negotiation must occur prior to the expiration date but actual presentment may occur thereafter.

1 Of course, common law contract law may supplement the particular letter of credit rules. *See* Dolan, *The Law of Letters of Credit* ¶ 4.01 (1984).

2 Even if the contract does not explicitly provide for reimbursement, the rules governing letters of credit impose on the customer a reimbursement obligation. *See* U.C.C. § 5-114 (3); U.C.P. Article 16.

3 Technically, the ICC has no authority to legislate and the U.C.P. does not have the force of law. The U.C.P. would seem to provide evidence of trade usage, and clearly constitutes persuasive authority with respect to the rules governing letters of credit. *See* Dolan, *The Law of Letters of Credit* ¶ 4.06 (1984). Certainly to the extent that the parties expressly incorporate the terms of the U.C.P. into their letter, the terms should become part of the contract and apply to the parties' relationship.

4 *See* Dolan, *The Law of Letters of Credit* ¶ 4.01 (1984).

5 According to Professor Dolan, there are four areas in which conflicts have arisen: (1) revocability of the letter; (2) transfer of the letter; (3) the time within which the issuer must examine the documents and determine whether to pay or dishonor; and (4) the fraud rule for stopping payment. Dolan, *The Law of Letters of Credit* ¶ 4.06 [2] (1984). These issues are discussed infra.

6 U.C.C. § 5-102.

7 U.C.P. Article 1 (1983 revision). Although Article 1 suggests that the U.C.P. applies to all documentary credits, it goes on to provide that the articles "shall be incorporated into each documentary credit by wording in the credit indicating that such credit is issued subject to [the U.C.P.]." This language could be interpreted as requiring explicit reference to the U.C.P. in the letter. Such an interpretation would, however, be unfortunate. *See* Dolan, *The Law of Letters of Credit* ¶ 4.04 (1988 cum. supp. no. 2).

8 *See*, e.g., Ala. Code § 7-5-102 (4) (1977); Ariz. Rev. Stat. Ann. § 44-2702 [D] (1967); Mo. Rev. Stat. § 400.5-102 (4) (Vernon Supp. 1983); N.Y. U.C.C. § 5-102 (4) (McKinney 1964).

9 *See* U.C.C. § 1-205.

10 *See* Dolan, *The Law of Letters of Credit* ¶ 4. 06 (1984).

11 U.C.C. § 5-103(1) (c).

12 U.C.C. § 5-114.

13 U.C.C. § 5-103(1)(g).

14 *Id.*

15 U.C.C. § 5-103(1)(d).

16 U.C.C. § 5-103(1)(e).

17 U.C.C. § 9-304.

18 U.C.C. § 5-107(2).

19 Dolan, *The Law of Letters of Credit* ¶ 2.08[3] (1984).

20 In very limited cases, the contractor may be able to enjoin payment of the letter if the owner has committed fraud in drawing under the letter. *See* U.C.C. § 5-114.

21 7 U.C.C. Rep. Serv.2d 832 (7th Cir. 1988).

22 U.C.C. 5-106.

23 *Id.*

24 U.C.C. § 3-410; 3-413.

25 U.C.P. Article 15.

26 U.C.C. § 5-112.

27 *See*, e.g., *Beyene v. Irving Trust Co.*, 762 F.2d 4 (2d Cir. 1985) (letter of credit required presentation of a bill of lading which named the party to be notified as "Mohammed Sofan." Actual bill of lading presented named party to be notified as "Mohammed Soran." Court held that document failed to strictly comply with letter of credit and that issuer was justified in dishonoring.); *Courtaultds North America, Inc. v. North Carolina National Bank*, 528 F.2d 802 (4th Cir. 1975) (letter of credit required invoice covering "100% acrylic yarn." Actual invoice presented covered "imported acrylic yarn." Court held that invoice failed to comply, justifying issuer's dishonor). *See also* U.C.P., Article 41(c) which states: "The description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the credit."

28 *See*, e.g., *Banco Espanol de Credito v. State Street Bank & Trust Co.*, 385 F.2d 230 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968).

29 *See*, e.g., *Transamerica Delaval Inc. v. Citibank*, 545 F. Supp. 200 (S.D.N.Y. 1982).

30 U.C.P., Article 16(e).

31 177 Misc. 719, 31 N.Y.S.2d 631 (1941).

32 *See* J. Dolan, *The Law of Letters of Credit* ¶ 7.04[3] (1984).

33 J. White and R. Summers, *Uniform Commercial Code* § 19.7 (3d ed. 1988).

34 Dolan, Standby Letters of Credit and Fraud (Is the Standby Only Another Invention of the Bankers in Lombard Street?), 7 Cardozo L. Rev. 1 (1986).

35 714 F.2d 1207 (3d Cir. 1983).

36 7(2) J. Moore, J. Lucas, and K Sinclair, *Moore's Federal Practice*, 2d ed. ¶ 65.04[1], at 65-32 (1988). While some courts of appeals apply these factors flexibly and hold that no single factor is determinative, the Fifth and Eleventh Circuits require that the movant carry the burden of proving each factor. *See*, e.g., *Libertarian Party of Texas v. Fainter*, 741 F.2d 728 (5th Cir. 1984). *See, generally* 7(2) J. Moore, J. Lucas, and K Sinclair, *Moore's Federal Practice*, 2d ed. ¶ 65.04[1], at 65-39, 65-52 (1988). For a description of the precise standards applied in each federal circuit, *see id.*

37 *See*, e.g., *John B. Hull, Inc. v. Waterbury Petroleum Products*, 588 F.2d 24 (2d Cir. 1978); *Aguirre v. Chula Vista Sanitary Service & Sani-Tainer, Inc.*, 542 F.2d 779 (9th Cir. 1976). *See generally* 7(2) J. Moore, J. Lucas, and K Sinclair, *Moore's Federal Practice*, 2d ed. ¶ 65.04[1], at 65-33-34, 65-48 (1988).

38 *Standard & Poor's Corp. v. Commodity Exchange, Inc.*, 683 F.2d 704 (2d Cir. 1982).

39 606 F.2d 10 (2d Cir. 1979).

40 U.C.C. § 3-302.

41 U.C.C. § 5-116(3); U.C.P. Article 16.

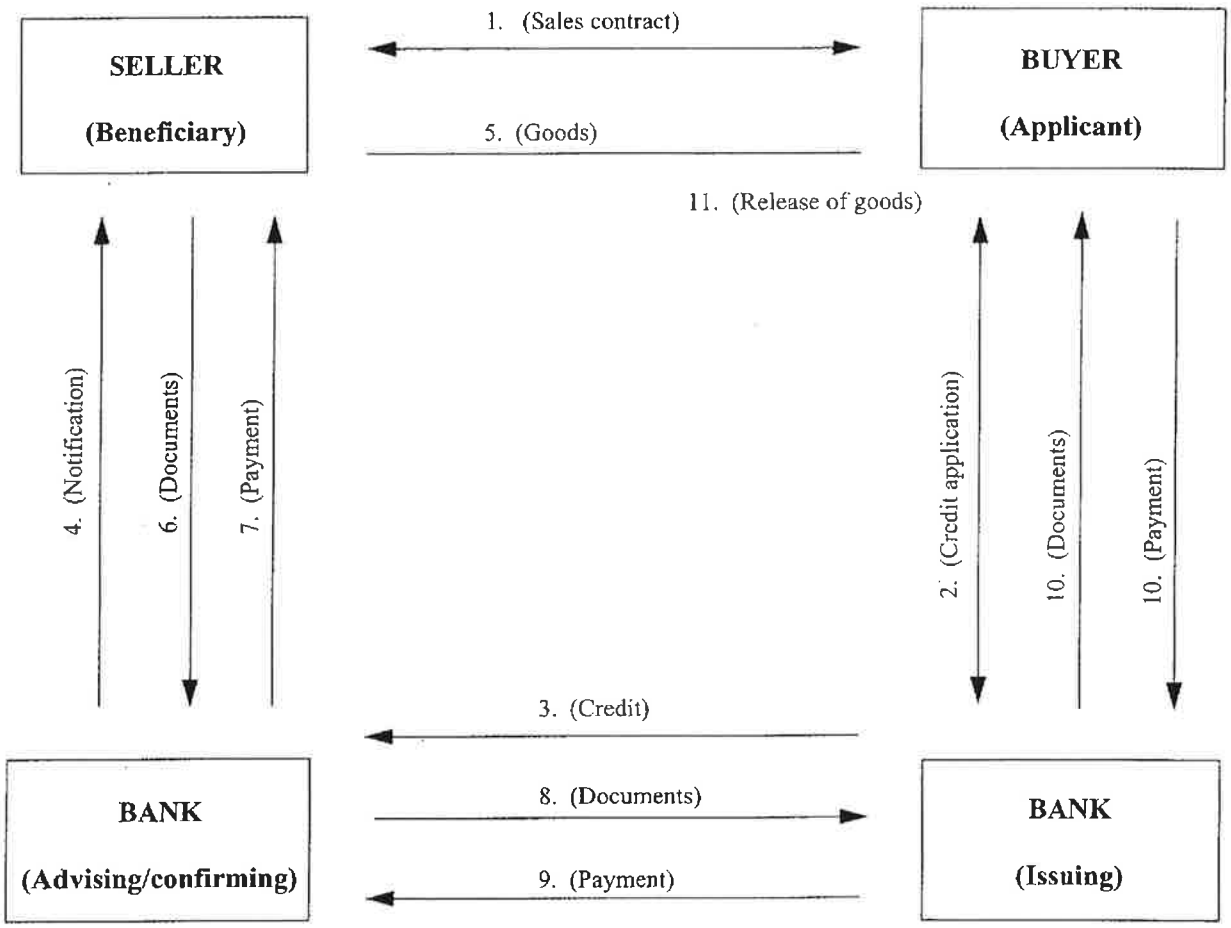
42 U.C.C. §§ 9-304; 9-305.

43 *See In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293 (11th Cir. 1988); *In re Compton Corp.*, 831 F.2d 586 (5th Cir. 1987).

44 U.C.C. § 5-116(1); U.C.P. 54(b).

Annex VII

THE STAGES OF A DOCUMENTARY CREDIT



ICC Force Majeure Clause 2003

ICC Hardship Clause 2003

Published in February 2003 by

ICC PUBLISHING S.A.
An affiliate of ICC: the world business organization
38 Cours Albert 1er
75008 Paris, France

ICC Publication No. 650
ISBN 92 842 1319 3

ICC
The world business organization

FOREWORD

By Maria Livanos Cattaui, Secretary General of ICC

Force Majeure literally means "greater force". Force Majeure clauses excuse a party from liability if some unforeseen event beyond the control of that party prevents it from performing its obligations under the contract.

A hardship clause, on the other hand, requests re-negotiation of the contract if the continued performance of one party's contractual duties has become excessively onerous due to an unforeseen event beyond the control of that party.

Negotiating force majeure and hardship clauses means operating at the very core of the contract. It is important that the clauses are balanced and apply equally to all parties to the agreement. ICC has designed the ICC Force Majeure Clause 2003 and the ICC Hardship Clause 2003 to facilitate the drafting process both for companies and for their lawyers.

These clauses follow extensive discussion within ICC's Commission on Commercial Law and Practice, and particularly within the Task Force on Force Majeure and Hardship, chaired by Prof. Jan Ramberg (Sweden). Draftsman-in-chief was Prof. Charles Debattista (UK), and other task force members were Prof. Filip de Ly (Netherlands), Alexis Mourre (France), René von Samson-Himmelstjerna (Germany), Fabian von Schlabrendorff (Germany), and Peter Delargy (France).

February 2003

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through the general formula established in paragraph 1, unassisted by the presumptions which would otherwise apply through the occurrence of a listed event. Thus, for example, where a party seeks relief because of a labour disturbance affecting only its own enterprise (and therefore comes outside event (g) – general labour disturbance) such a party can still invoke force majeure if it can establish the three requirements set out in paragraph 1.

f) Self-induced Force Majeure

The ICC Task Force on Force Majeure and Hardship has chosen not to include an express article excluding from relief events to whose occurrence the party invoking the clause has contributed, i.e., an article similar to CISG article 80, an article which is not repeated, incidentally, either in the Principles of European Contract Law or in the Unidroit Principles for International Commercial Contracts. The condition laid down at paragraphs 1(a) and (c) of the Clause dispense with the need for such an article: an event to which a party has contributed in whole or in part cannot be one outside the control of that party or one whose effects he might not reasonably have avoided or overcome.

g) Force Majeure and freedom of contract

It should be emphasised that this Clause is subject, both at paragraph 1 and 3, to the contrary agreement of the parties whether express or implied in the terms of the contract. A number of examples of such special clauses have already been given in these Explanatory Notes. Again, for example, the parties may have expressly agreed by special term that the supplier was under a contractual duty to obtain an export licence, in which case it would not be open to it to invoke a governmental order, listed at paragraph 3[d], unless the failure to obtain it was caused by another of the listed events.

h) The consequences of Force Majeure: paragraphs 4 and 5

Paragraphs 4 and 5 of the Clause represent the two consequences suggested by the Task Force as resulting from the invocation of the clause, namely, suspension of performance duties and of remedies in damages for the duration of the impediment or event.

i) Force Majeure leading to termination of the contract: paragraphs 8 and 9

The Task Force was faced with two options regarding the moment at which temporary suspension of the contract through force majeure would last long enough to lead to termination: the first was to establish a fixed period; the second was to provide a formula for calculating that period. The Clause adopts the latter approach because it was felt that it would be difficult to establish a single period, which would be appropriate for all sectors of industry and in all circumstances. The formula used is that employed by CISG article 25, the Unidroit Principles for International Commercial Contracts article 7.3.1 and the Principles of European Contract Law section 8:103, with the caveat, however, that reference to foreseeability has been omitted, this aspect of matters being rendered superfluous by paragraph 1[b] of the Clause.

j) Force Majeure and notice

The giving of notice is referred to in paragraphs 4 and 5, 6 and 8 of the Clause. It is felt that mention of notice in these paragraphs dispenses with the need of a general article on notification, setting out a duty of notice within a reasonable period and the consequences of a failure to notice. The scheme of the Clause makes the consequences of invoking the Clause contingent upon notification without delay, a sufficient incentive to a party wishing to invoke the Clause to give prompt notice to the other party of its intention so to invoke.

ICC HARDSHIP CLAUSE 2003

Introductory Note on the Application of the Clause

This clause, known as the "ICC Hardship Clause 2003", is intended to apply to any contract which incorporates it either expressly or by reference. While parties are encouraged to incorporate the clause into their contracts by its full name, it is anticipated that any reference in a contract to the "ICC Hardship Clause" shall, in the absence of evidence to the contrary, be deemed to be a reference to this clause.

1 A party to a contract is bound to perform its contractual duties even if events have rendered performance more onerous than could reasonably have been anticipated at the time of the conclusion of the contract.

2 Notwithstanding paragraph 1 of this Clause, where a party to a contract proves that:

[a] the continued performance of its contractual duties has become excessively onerous due to an event beyond its reasonable control which it could not reasonably have been expected to have taken into account at the time of the conclusion of the contract; and that

[b] it could not reasonably have avoided or overcome the event or its consequences,

the parties are bound, within a reasonable time of the invocation of this Clause, to negotiate alternative contractual terms which reasonably allow for the consequences of the event.

3 Where paragraph 2 of this Clause applies, but where alternative contractual terms which reasonably allow for the consequences of the event are not agreed by the other party to the contract as provided in that paragraph, the party invoking this Clause is entitled to termination of the contract.

Notes

a) Hardship and Force Majeure

The ICC Hardship Clause 2003 stands separately from the ICC Force Majeure Clause 2003. This has been done for two reasons. First, clauses providing for the consequences of force majeure events are more commonly used than hardship clauses: it was felt that making both clauses operate automatically by incorporation might discourage the use of the force majeure clause. Secondly, the two clauses operate in different circumstances and have different effects; they ought therefore to be kept separate. Having said that, ICC puts forward both clauses as fair allocations of risk in circumstances of force majeure and hardship and both clauses can, of course, be incorporated into the same contract.

b) The origins of the Clause

The Clause differs markedly from the ICC 1985 Hardship provisions, which gave four alternative options for adoption by contracting parties. The Clause now provides one formulation with clear alternative consequences, negotiation or termination, the latter of which would in most cases provide an incentive towards the former. The Clause amalgamates elements of article 1467 of the Italian Civil Code and of article 6.2.2 of the Unidroit Principles of International Commercial Contracts.

c) The parties should perform their duties: paragraph 1

The Clause, taken largely from article 6.2.1 of the Unidroit Principles, starts with the principle that contractual duties should normally be performed, otherwise known as the principle "pacta sunt servanda". On one view, this paragraph is unnecessary, in that hardship could only be invoked if the rigorous tests of paragraph 2 are satisfied, and this would be the case whether or not there is a paragraph 1. On the other hand, it was felt that the explicit expression of the "pacta sunt servanda" principle gives tribunals a clear indication that paragraph 2 is only to be invoked where its conditions are very strictly satisfied, it being an exception to the usual requirement of performance. It is with this in mind that the phrase "more onerous than anticipated at the time of the conclusion of the contract" is used in paragraph 1 (in which case duties must be performed) and the more demanding phrase "excessively onerous" in paragraph 2(a) (in which case there might be relief from performance.)

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d) Hardship and existing impediments

As with the ICC Force Majeure Clause 2003, this Clause is not limited to situations where the events rendering performance excessively onerous occurred after the time the contract was concluded. Here too, the Task Force decided against such a limitation on the ground that a party might wish to invoke the Clause in circumstances where it simply did not know – and could not have known – of the existence of the event at the time of the conclusion of the contract. Again here, however, if the parties wish to apply the consequences of the Hardship Clause solely to events which occur after the contract is concluded, there is nothing in the Clause limiting their ability to do so by special term in their contract. Care should be taken in such circumstances, however, because such a clause would have the effect of excluding the consequences of the Clause where events rendering performance excessively onerous existed at the time of the conclusion of the contract but were unknown to the parties.

e) Hardship and the duty to negotiate: paragraph 2

The Clause places upon the parties the duty to negotiate alternative reasonable terms without expressly referring the matter to a court, as is done in article 6.2.3 of the Unidroit Principles. It was felt that the ICC Hardship Clause should encourage the parties to work out their own solutions through a general dispute resolution clause in their contract, rather than expressly stipulating for a limited reference to a tribunal for re-negotiation in a hardship situation. A "special" dispute resolution provision for hardship cases co-existing with a general dispute resolution clause might cause unnecessary and undesirable confusion. Thus, where paragraph 3 does not work, either because the performing party fails to offer alternative terms or because the non-performing party fails unreasonably to accept them, then the likelihood is that a claim will be made, either for termination brought by the party invoking the Clause or for breach of contract brought by the other party. That claim would go to arbitration or litigation under the general dispute resolution terms in the contract, for example by reference to any of the dispute resolution services provided by ICC.